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ALSO PRESENT:

DAVID L. HOFFMAN, Court Reporter

FEDERAL ENERGY REGULATORY COMMISSION
INVESTIGATION OF TERMS AND CONDITIONS OF PUBLIC
UTILITY MARKET-BASED RATE AUTHORIZATIONS

(9:35 a.m.)

MR. BARDEE (Presiding): Good morning. If people will take their seats, we'll go ahead and get started. My name is Michael Bardee with the Office of General Counsel. On November 20th last year, the Commission proposed a new condition to be added to all market-based rate tariffs for resales by public utilities. That condition would address anticompetitive behavior and exercises of market power and allow the Commission to impose remedies such as refunds or other types of remedies.

Let me just describe real briefly the agenda for this morning, and then we'll turn it over to Staff for a presentation. The agenda this morning will have a presentation by Jerry Pederson and Joyce Kim, describing some of the background, some of the comments, and some of the issues before us today.

Then we'll have a panel discussion. We have seven panelists here. The panelists will be allowed a few minutes to make a brief opening statement. Then we'll have questions and answers interaction with the Staff. We'll take a short break after that, then we'll come back and we'll have an open mike session where members of the

audience will be allowed to come up and make brief statements, ask questions, respond to Staff questions.

With that, I'll turn it over to Jerry Pederson and Joyce Kim for their presentation.

MS. KIM: Thanks, Mike.

(Slide.)

In the November 20th order in this proceeding, the Commission noted its increasing concern about the potential for public utilities with market-based rate authorization to exercise market power or engage in anticompetitive behavior that could result in unjust or unreasonable rates. The Commission proposed to take steps to minimize the potential for any such market power abuse or anticompetitive behavior to protect customers against possible unjust and unreasonable rates.

In particular, the Commission proposed to revise all existing market-based rate tariffs and authorizations to include the following provision: As a condition of obtaining and retaining market-based rate authority, the seller is prohibited from engaging in anticompetitive behavior or the exercise of market power. The seller's market-based rate authority is subject to refunds or other remedies as may be appropriate to address any anticompetitive behavior or exercise of market power.

The November 20th order provided for an

opportunity for interested entities to file comments and reply comments regarding the proposed tariff condition. In response to requests for an extension of time, the Commission subsequently extended the time for filing initial comments to January 25th, 2002, and extended the deadline for filing reply comments to February 5th, 2002.

A notice issued on February 25th, 2002 announced that a Staff Conference would be held to discuss issues raised in the comments and reply comments filed in this proceeding. The notice stated that the conference will not address issues specific to the new generation market power screen, the supply margin assessment that the Commission announced in another proceeding.

A subsequent notice listed on March 1, 2002, and posted on the Commission's Web site included a staff paper which provided an overview of the comments and identified possible modifications to the proposed tariff condition. That notice indicated that the purpose of this conference is to determine whether and how the proposed tariff condition could be modified to address legitimate concerns that have been raised by the commenters, while at the same time satisfying the Commission's concern that customers be protected against unjust and unreasonable rates that may result from anticompetitive behavior or an exercise of market power. That notice further stated that a key

question to be considered is whether the proposed tariff condition can be modified to adequately protect customers on an interim basis until such time as the Commission adopts other measures to assure competitive markets, including standard market design rules with market power mitigation rules where appropriate, and establishment of RTO market-monitoring units.

At this time, Jerry Pederson will lay out the issues that are the subject of today's conference.

MR. PEDERSON: Commenters concerns.

(Slide.)

Concerns have been raised over what is the best approach for ensuring that companies do not engage in anticompetitive behavior and the exercise of market power. We've received numerous comments, both in support and in opposition. Those we received in opposition generally argued that the tariff provision is unacceptably broad. Terms such as market power, physical and economic withholding, incremental costs and market price are vague and too narrowly defined. These commenters generally argue that because the definitions do not consider physical, institutional and regulatory constraints, suppliers will be subject to remedies and/or refunds in many cases where they're simply making reasonable business decisions and not exercising market power.

Comments in support argue that the proposed tariff condition is necessary to ensure that rates are just and reasonable. Some supporting commenters would favor modifications to the definitions of prohibited behavior to strengthen the condition. Presented on this slide are two general areas we would like to discuss and concentrate on today. The first one is what I referred to is definitions. What constitutes anticompetitive behavior or the exercise of market power, the second is procedures.

What remedies will the Commission impose, and what effect will they have on infrastructure. Generally comments in opposition are looking for better understanding of what constitutes prohibited behavior. Commenters argue that as proposed, the tariff provision creates too much refund uncertainty. They are concerned that they will have a cloud of refund potential obligations hanging over their heads which could lead to continual restating of their financial statements, a disruption in reselling contracts, and a difficulty in assessing risk. Market signals could be distorted, fixed costs not recovered and a difficulty in securing finances for needed infrastructure. Comments generally in support argue that anticompetitive behavior or the exercise of market power are issues that can make or break the successive restructuring.

In terms of certainty, they point out that as the

Commission is presented with refund claims, it will be able to better identify and explain factors relevant in determining whether or not refunds are warranted. They also counter the claim that uncertainty will harm the ability of generators to raise capital by pointing out that a lack of confidence in the ability of the industry to buy energy at reasonable rates can also lead to difficulty in gaining access to capital for a large variety of businesses.

(Slide.)

The purpose of today's conference, our hope today is that we can concentrate on feedback as to how the Commission might approach concerns raised by various interests in this proceeding. We've heard the pros and cons. We've spilled a lot of ink on this subject and it's clear there's a lot to consider.

Today, we're going to ask the panel and the audience to concentrate not on what's wrong with the order but rather on how we can develop a proposal to present to the Commission for its consideration. We ask that your recommendations and comments be for the industry as a whole, rather than interest-based. We want to look at ways to add greater certainty in how the Commission might determine anticompetitive behavior or the exercise of market power. We want suggestions on what additional examples of such behavior will help add certainty.

We're also looking for some suggestions on how we can limit exposure for everyone involved.

(Slide.)

Examples of prohibited behavior. The order went through three examples, and I'll briefly go through them right now. The first one is physical withholding. The order finds physical withholding is occurring with a supplier fails to offer its output to the market during periods when the market price exceeds the suppliers full incremental costs. Commenters argue that there's a lot of difficulty in identifying physical withholding.

In the cases of energy limited units, outage risk and operating risk, if the supplier cannot bid sufficiently high to avoid running all their capacity, they will simply hold back some or all of that output, even when the market price is greater than the full incremental cost. They also argued that a plant operator needs to be able to decide what is the best time to take a plant out of service or to run it at less than full capacity for reliability purposes. If the operator faces the risk of having the unit's revenues subject to refund, or having its market-based rate authority revoked or suspended, it may be forced to operate the plant in a way that reduces reliability.

The second example is economic withholding. The order defined economic withholding as occurring when a

supplier offers output to the market at a price that is above its full incremental cost and the market price; thus the output is not sold. Here again commenters are concerned over how economic withholding will be identified. They argue that much of the market activity takes place in bilateral markets where the supplier has paid its bid. In those markets, competitive suppliers base their bids on a perceived value of their product, not merely on marginal costs of production.

For units that are constrained by the number of hours they can run, such as hydro facilities or plants facing emissions limitations, the opportunity costs of running in a given hour is a foregone profit in another hour. Commenters argue that suppliers must bid in excess of running costs in order to account for these opportunity costs.

Today, we want to talk about physical and economic withholding. We want to hear your suggestions and proposals in terms of definition and examples of what should and should not be covered.

The last factor that was presented in the order is barriers to entry. The order defined barriers to entry as withholding supplies that could also occur when a seller is able to erect barriers to entry that can limit or prevent others from offering supplies to the market, or that raise

the cost of other suppliers.

Those are the three prohibited behaviors identified in the order.

(Slide.)

I'm going to go through a short list of four items that we wish to discuss today. The first is other examples of prohibited behavior. We want to hear from you about examples of prohibited behavior other than those identified in the November 20th order. Are there others that we should consider? If so, give us some examples that will help add some certainty that you are looking for.

The second item is legitimate factors based on comments regarding the definitions of physical and economic withholding. Are there ways to take into account legitimate environmental operational or reliability factors to determine whether a seller who fails to offer output to the market or offers it at a price considered too high has engaged in physical or economic withholding.

The third item is market price. How can the Commission be more specific regarding how it will determine market price in a particular case? How does that vary between forward versus spot, energy versus reserves, or the geographic market.

And the fourth item would be opportunity costs. Should legitimate and verifiable opportunity costs be

included in determining full incremental costs? If so, should these costs be included only for energy limited units?

(Slide.)

This last slide, options for limiting uncertainty, is really pointing at what I'll refer to as procedures. We talked about concerns over uncertainty and have presented questions that are intended to get ideas on how definitions can be changed or supplemented to reduce that uncertainty. Here we would like to begin to look at some procedural tools. Challenges that an entity is in violation of a tariff provision will come in the form of a complaint or by the Commission's own action, and we'd like to present a couple questions here.

The first one is, in order to limit exposure, should claims of anticompetitive behavior exercise of market power be tied to specific transactions? And should any refund-related relief also be tied to the specific transactions identified?

The second question takes it a step further. Should the Commission limit the time period for filing such allegations so that transactions would not be subject to refund unless specifically challenged within a particular time frame.

These questions are aimed at pricing dispute

tying complaints to a specific transaction, would eliminate fishing expeditions and require very specific allegations. Limiting the time period for filing those allegations could add a bit of certainty. We would like to hear your suggestions on limiting refund exposure including what could constitute a reasonable time period for filing complaints.

That ends Staff's presentation.

MR. BARDEE: Thank you, Jerry and Joyce. If the panelists could now take their seats along that side of the table as well. We have seven speakers on our panel this morning. I'll introduce them one by one as each makes a statement. I would ask that you limit your opening statement to five minutes apiece. Then we'll have time for Staff to ask questions and you all to respond and give and take both ways.

First, I'd like to introduce Mr. Steven Cadwallader from the Connecticut Department of Public Utilities Control. Please go ahead.

MR. CADWALLADER: Thank you. My name is Steven Cadwallader, Chief of Utility Regulation with the Connecticut Department of Public Utility Control. On behalf of the Connecticut DPUC, I'd like to thank the FERC Staff for giving us this opportunity to direct our comments regarding market power and anticompetitive behavior directly to you.

First off, the objective of the Connecticut DPUC is to try to make the electricity markets as competitive as possible, and to make those markets behave like competitive markets. We see anticompetitive behavior and the exercise of market power as being a significant barrier to the ability of those markets to act competitively and to be efficient and effective in distributing power to the nation. We applaud FERC's proposal to add this tariff condition. We think it's a significant step in the right direction. We believe it provides the kind of overarching prohibition against anticompetitive behavior and the exercise of market power that is needed. We don't believe that you can curb the exercise of market power effectively unless you have some sort of overarching prohibition. If you try to run around chasing market behavior, anticompetitive behavior and the exercise of market power through specific rules and narrow interpretations of those rules, you're never going to effectively do it.

We think it's appropriate to use the behavioral approach with regard to combating market power and its exercised, while we think structural approaches are preferred, we don't think you can do it entirely with structural approaches. We think this market and the particular peculiarities of the market, such as balancing supply and demand instantaneously in real time, moment to

moment, and also the fact that when supplies become constrained, it's very easy to withhold supplies and exercise market power in that way. We don't think structural approaches can do it by themselves.

We also think that we need to go about the business of addressing anticompetitive behavior and the exercise of market power sooner rather than later. We think the refinements to the rules and all can come through Commission decisions as experience with the tariff conditions is gained.

Those are the prepared remarks I have for this morning. Thank you.

MR. BARDEE: Thank you, Mr.. Cadwallader. Next is Ms. Julie Simon from the Electric Power Supply Association.

MS. SIMON: Thank you. I'm Julie Simon with the Electric Power Supply Association. As I think all of you know, we are a national trade association representing the competitive power supply industry. Our members build and operate power plants, sell at wholesale and at retail in markets nationwide and in fact around the world. We filed very strenuous objections to the November 20th order, and I will not take the time to repeat those. We did include the testimony of two experts, one was Richard Tabors, the other was Branko Terzic, explaining the concerns that we had.

We have also prepared two documents for today's conference. They're a little bit confusing because they have similar titles. One of them, EPSA Response to the Staff Paper, the other is an EPSA Response to the specific questions asked in Attachment B to the Notice of the Staff Conference Agenda. Those two documents are available in the back. We can make more available if anybody didn't get them.

I want to step back for just a second in some opening comments and try to put this in a little bit of context for people. We are obviously concerned about the exercise of market power. We think the Commission and the Commission Staff is correct to be focused on this. It is an important issue and it raises serious concerns about the workableness of a competitive market if it is in fact riddled with abuses of market power. It will undercut the benefits that we can bring to that marketplace. The question is how to go about remedying that, and exactly what the problems are. It's very important in proceeding here to be extraordinarily clear about exactly what problems we are seeking to solve, what the time frame is for solving those problems, and what the appropriate remedies for those problems are.

As I understand the proposal -- and I could be wrong here -- we are looking at a somewhat interim approach

until we can complete the standard market design and have it place RTOs and market monitoring on a national basis.

Having said that, however, many of the cautions and ideas included in the Chairman's strawman that was produced on February 7th, are equally applicable to the markets that exist today.

We are not functioning on a blank slate here. We already have RTOs up and running and operating medium well functioning markets in the northeast for example. Those markets have been studied and been found to be quite competitive. So when we talk about addition market mitigation and market intervention, we have to be very careful to recognize that at least in those markets, they are functioning reasonably well. There's a recent report on New England, for example, that found that generation market power did not explain any delta between the prices that we saw and the prices that would have been expected.

In California, in fact in the entire west, at least in the near term, we are operating under a system of heavy intervention and mitigation that is already in place. So when we talk about what areas we're looking at and what problems we're trying to solve, at least in my mind, the problem becomes significantly narrowed. There are regions of the country that are not operating under RTOs or operating organized spot markets. Those markets operate

with bilateral contracts, and as many of the commenters have already pointed out to you, those contracts largely reflect the result, in fact exclusively reflect the result of sophisticated buyers and sellers making risk management decisions, and intervention into those contracts would be an enormously difficult and troublesome thing for this Commission to do, particularly since the refund condition is completely one-sided. You're opening the door for one party to those contracts, the buyer, to bring to you every example of buyer's remorse, and I can't imagine that that's a Pandora's Box that you want to open, particularly to remedy a problem that has not been identified.

Those markets, although they don't operate as spot markets, do have fairly robust trading operations at several locations with sophisticated players that are used to operating in those markets. It's also important to keep in mind that although market power is a bad thing, it is manifest in many ways; it's unlikely that any silver bullet is going to solve the myriad of problems this Commission faces. If in fact market power is caused by vertical integration, then you have one problem. If it's caused by barriers to entry, you have a different problem. If it's caused by bad bidding behavior, you have a third problem.

But I haven't seen any evidence that the vast majority of the market power concerns that this industry

faces are as a result of the type of behavior that this condition is intended to remedy. As Greg Wood and others have pointed out to you in the past, you have to be very careful about not solving a problem with a remedy that is far more costly than the problem that you're going about solving. This is a situation where in fact the cure may be far worse than the disease and we need to be very cautious in proceeding.

I just want to close by suggesting some things that the Commission could do in the short term to remedy some of the concerns about market power. Obviously, standard market design is critical, interconnection is critical, but if the Commission is concerned about some immediate and short term problems, we urge you to look at the type of mechanisms that you have adopted in the past to get more supply into the marketplace and to get demand response into the marketplace quickly. The best protection against market power is customers' ability to access a variety of supplies in an efficient manner. In the past, for example, over summer periods, you have permitted on-site generation to sell at market-based rates any excess power into the grid. You have allowed those demand side participants who can access the wholesale markets to sell at market-based rates. If the concern is scarcity for the summer outside the organized markets which already have

intensive mitigation and outside of the west which already have intensive mitigation, you might look at the type of conditions and the type of authorizations that you considered an EL0075 and EL00147 each of the last two summers, but ultimately the best way to protect consumers is to get a robust marketplace working as quickly as possible to focus people's attention on how to do that efficiently and to look at ways to get the maximum amount of supply onto the grid.

Let me just close by saying that to the extent that in the context of the development of standard market design, we want to look at types of price caps and protections. They are also relevant in the short-term as well. We need to think about the consequences. We need to do a lot more research. We are certainly open to the possibility of a thousand dollar bid cap on a nationwide basis, but when we get into the types of market interventions that the Chairman has talked about with amp-like mechanisms, those have an enormous amount of unintended consequences and need to be developed very carefully, not done on the back of an envelope. They need to be modeled, the consequences need to be understood, and we urge you to pursue that process carefully as well.

I thank you very much for the opportunity to be here today, and look forward to the discussion.

MR. BARDEE: Thanks, Julie. Next is Mr. Scott Harvey, Director of LECG.

MR. HARVEY: Thank you. I'm a consultant in the electric industry and I'll try to draw on a number of my experiences in my comments. Preliminarily, though, the usual disclaimer -- I'm speaking for myself -- I don't belong to anybody else; in particular, I'm not speaking for the New York ISO or the Midwest ISO.

A few observations, I think. First I'm going to give you some strong advice, and then some reasonable people can disagree advice. First, I think it would be a very bad idea to have a broad application of the refund condition that applied to all entities in the market including those that did not exercise market power. But if you're going in and say that we're going to restate the prices for everybody in this market because Scott Harvey withheld, and we're going to renegotiate the price, and everybody else gets paid for their output, you're going to end up doing exactly the opposite of what you want. You're going to reduce the competitive response of the small players to increases in output, and the further forward you apply that criterion, the worse the effects are going to be. If you restate contracts that the small competitors enter into, it means you're going to discourage entry; you're just going to make it more difficult to find finances and more risky to come

in.

If you apply it on a day-ahead basis, it means that small players, like cogen plants, won't be willing to change their schedules day ahead, units will not make commitment decisions. People will not make resources and scheduling resources from outside the RTO. In real time, the effects of restating it are less because most things are fixed, but people are still not going to respond to the high prices if they think there's potential for it being reversed. In fact, even the application of your criteria will become more difficult if you apply it to people who aren't exercising market power because the reason they don't respond to the high prices is that they may not believe it's going to stick.

Secondly, if you have a narrow application, say this refund condition is going to apply to the entity, that's Scott Harvey that withheld output, I can understand if you get into a situation where I bid all my capacity at \$10,000 a megawatt and there's some lines out that aren't usually out and I've got everybody by the throat, you could say, we've got to do something about that. One thing you could do is say, okay, you tricked us the first time market-based rate authority. We're going to take it away. The second thing is maybe you could apply a refund condition. I can see how you might go that way. Reasonable people could

pursue that strategy, but you need to understand the consequences of the road you're going down.

As Bill and I pointed out in our testimony, there's a lot of complications in understanding economic withholding in terms of energy limited units, in terms of environmental limits, in terms of physical withholding and the operation of units. Those are difficult and it's going to be a major effort.

In answer to a couple of the things you said, what do we do in terms of defining the market price? How do we define what's a legitimate and verifiable opportunity cost? The answer is, it depends on the market rules. I thought about this, and I don't think I'm convinced that I cannot come up with a reasonable set of rules for most of the questions you asked that's independent of the market design.

Therefore, it's going to be an inquiry. We're going to have to look at, given the structure of this market, were these actions and bids reasonable, or do they constitute economic withholding. So it's going to be a serious inquiry.

The answer to how do you take into account the legitimate factors is a serious inquiry, and you shouldn't kid yourself about that. So if you go down that road, I think it then behooves you to say, well, let's cut out all

of the irrelevant stuff we can, and I think back to when I was in the Federal Trade Commission looking a very, very big mergers like Gulf/Chevron. We didn't investigate every insignificant market where we couldn't possibly have an exercise of market power. We focused on where is there a reasonable case that there could be an exercise of market power, then work hard there.

So if you're going to go down this road, I would first start by saying here are all the places where there couldn't possibly be market power and exclude them; otherwise you're going to be buried.

The third point is that there's a real danger here. The gains from competition are going to come from giving people more choices. To some extent, if we're going to get the gains of competition and generation, we're going to have to let go. And if you try to instead micromanage, particularly operating decisions of plants and the judgment of when do you take a plant down, when you do you gamble you can keep it up, when do you think if I ramp it down now I have a better chance of keeping on through tomorrow, you're probably going to get the worst outcome. Because you're going to end up with regulatory micromanagement of decisions where people are probably going to do the wrong thing and you're still going to have prices that can go high.

And at some point you have to decide we're going to set up a competitive market and we're going to let it happen. And I think some of the bad outcomes we've seen, and I go back to the Commission's evaluation of Amendment 23 in California, was that there was lots of micromanagement of generator decisions going on. And the outcome of some of the things that happened in 2000 and 2001 I think maybe they were not market power, but the outcome of micromanagement, and that there's a real downside of going down that path. So, again, you want to be real careful. There may be situations where you have to step in and do something, but there's a lot of downside if you get into particularly

looking at the operation of the plants.

Fourth, I'd like to reiterate what I said last time, is divestiture is not a four-letter word. The way to make your task simpler is if someone comes to you with a merger and you really don't think that they've solved the market power problem, then just say no. Don't give them market-based rate authority until they solve it. And if someone comes with a radical restructuring of their company that's going to radically change their position between being a buyer and a seller in the market, don't just roll over and give them market-based authority for the new entity. Require divestiture before they get it. It's a lot easier to fix it that way.

Someone said, I don't think it was the Commission, but someone said anytime you've got an RTO, the people should get market-based rate authority. No, no, no, no, no. You'd be putting the RTO at the bottom of a deep well because you can create situations and structures where it just becomes impossible for the RTO in any fair manner. without mitigating everything that happens, to make up for the market power. So divestiture is best.

The fifth point goes back to something David Patton said last time we were here that I should have echoed then but didn't, and that is remember that a lot of the political problem over high prices isn't really about market

power. It's about periods in which we all know there was really a shortage. And most of the high prices are in periods of shortage. And the issue is, is the level at which prices go in a competitive market, in a shortage, appropriate under the current institutions? If we're five megawatts short of reserves, 30-minute reserves in New York, is the price of all capacity really \$1,000 a megawatt? And that is an issue that does involve FERC.

And if you say we don't want to be \$1,000, you've got to remember, under the current rules, you're not imposing competition to drive it down, you need to suppress competition to not have the price go to \$1,000 when there's a shortage. And if you don't think the price should be \$1,000 for Mcf in a shortage, we need to think about the way the NERC standards are applied to ISOs and RTOs.

Thanks.

MR. BARDEE: Thank you, Mr. Harvey. Next is Mr. John C. Hilke from the staff of the Federal Trade Commission.

MR. HILKE: Thanks very much. I'll begin my remarks with a disclaimer as well, since as a government agency, the FTC also takes positions, but my remarks are just my own today and don't purport to be the position of the FTC or any individual Commissioner.

I'd like to violate one of the rules that you

started out expressing, and that is to not talk about the screening process in the context of this discussion. I think they're inextricably linked, and in part the reason why we're having this discussion is because the initial screen that's been used to decide whether to grant market-based rates has had some problems. So I think there's ample indication that improvement of that screen may make this whole discussion more or less relevant.

Clearly, my preference is to try to make the screen as accurate as possible to begin with, which will relieve the pressure on this set of discussions.

Historically we're here in fact because FERC found that after it had granted market-based rates in some instances, they didn't believe that the rates were still just and reasonable. So this now comes to the question of are we looking for something permanent or something temporary to do about that? And the hope is that it's temporary, because under well developed markets, there hopefully will be less problems.

Clearly, the critical element in well developed markets which is missing right now is demand responsiveness. So it isn't clear just as an RTO you can get as far as you need to get to develop well developed markets.

So coming back down to sort of what messages do I think you should take out of this, the first is that

improving the market-based rate screen is a good idea, but that anything really short of doing full computer simulation and analysis of load flows, as so many of the states have done to try to figure out whether they've got market problems, is going to leave you short of where you probably need to be.

It's highly likely that when accurate screening is done that there will be some areas in which there will be periods of time when it's appropriate to have market-based rates and others when it may not be. So that there's going to need to be a time dependence on the judgment and not a judgment which applies under all circumstances.

It's also not clear that such screens should only be applied in non-RTO areas. I would echo what Scott just said that structure can make enough of a difference that an even an RTO can't get done what needs to be done.

The other message and one more directly on point with the claimed topic for today is that behavioral rules are just really difficult to implement in an efficient and equitable manner. And it isn't, you know, just your own sense of what's right about getting the rules right, it's also that these rules and the application of them are going to be reviewed by the courts. And the courts are going to look at whether an innocent man is being convicted unjustly. So you're going to need to basically design these things to

sustain that kind of test. And as our own experience indicates, sometimes the judgments of the courts may be different than our own.

So in the process of trying to put together these rules in a behavioral rule sense, these difficulties that we've identified in our comments and other people have identified in their comments, it is probably not impossible to get them all fixed. But if they become complex enough, you get yourself into a situation where the enforcement process is so uncertain and the chances of error both ways become so great that it almost becomes an unworkable situation.

And that's sort of why I feel that focusing on the structural stuff beforehand and getting that right and getting those remedies in place makes more sense than putting a lot of emphasis on the behavioral rules. So at least from our experience, the behavioral rules are going just become really problematic and a source of great uncertainty in these markets.

And the final thing I'd like to add is that I really encourage you to think about a feedback mechanism. If it turns out that under these behavioral rules you identify areas where there are recurrent problems, that ought to act as a trigger for you to initiate more aggressive experimentation in terms of siting authority, in

terms of transmission construction, in terms of your connection rules. If you're developing all these other good things which will help markets work better, one logical thing to do is to focus those efforts early and often on the areas which might give rise to claims under the behavioral rules.

Thank you.

MR. BARDEE: Thank you, Mr. Hilke. Next is Mark M. Jacobs from Goldman Sachs and Company.

MR. JACOBS: Great. Thank you. I very much appreciate the opportunity to be here with you this morning and share with you our thoughts raised by issues raised in these proceedings.

By way of background, I'm the managing director in the Investment Banking Division in Goldman Sachs. My specific responsibilities include working with companies on a wide variety of matters, including equity and debt financings, mergers and acquisitions, and general corporate finance advisory assignments. While I work in a wide variety of industries, I have a particular focus in the power sector.

Given my background, my comments will focus on the perspective of the capital markets and the impacts on companies' ability to raise capital to finance and construction of new power plants. Prior to summarizing our

concerns with the FERC orders, I believe that it's important to briefly discuss the state of the merchant generation sector. Given the high cost of constructing new generation plants, access to external capital has been a prerequisite for almost all companies embarking on a strategy of developing new power facilities.

Since 1999, companies focused on building a merchant generation portfolio have raised nearly \$80 billion in the capital markets. Capital has been raised in a variety of forms, including common equity, convertibles, debt, and project financing.

The merchant power sector has gone through dramatic changes in the last 12 months. The average stock price decline for pure play merchant generators is down over 60 percent since the beginning of 2001. The reduction in equity values in this sector has been driven by investor concerns over lower spark spreads in long-term growth prospects for merchant generators as well as the overall market decline. As a result, the average 2002 price earnings multiples have declined from approximately 20 times to single digits.

The Enron collapse has also had a meaningful impact on the sector. The credit rating agencies have aggressively re-rated the sector downward, meaning that companies will not be able to rely on debt financing as much

as they have in the past. In addition, credit spreads for the borrowing costs for these companies have widened significantly.

The Enron situation has also raised investor concerns regarding the integrity of financial statements. Accounting issues have recently surfaced at several other well known companies, both within and outside of the power sector, leading to a crisis in the confidence of reported earnings figures. Power generators with trading businesses have come under particular scrutiny.

These changes have dramatically increased the cost of and access to external financing for merchant generators. These conditions have also led to dramatic cutbacks in the planned construction of new generation facilities. Since December of last year, five companies have announced reductions in planned capital expenditures for 2002 alone, totaling \$6.8 billion. Moreover, it's unlikely that construction will be started on projects in the development stage until these conditions improve.

It's against this industry backdrop that we consider the impact of the FERC orders. There are two aspects of the FERC orders that we believe will be viewed negatively by the market. First we believe that there's a strong likelihood that investors will perceive that the orders create a potential open-ended refund obligation for

industry participants with market-based rate authority.

Coupled with investors' concerns regarding the integrity of financial statements, we're concerned that the implementation of the orders could potentially exacerbate the situation by requiring companies to restate earnings from prior periods. If this occurred, investor confidence in reported earnings figures would be further eroded.

Second, we're concerned with the complex concept of economic withholding will be viewed as impairing the ability of companies to not only recover their substantial fixed costs but also to earn an appropriate rate of return on their investment.

We're also concerned that investors will develop the perception that companies in the industry have capped upside in periods of scarcity but no downside protection in periods of surplus.

In light of current market conditions, raising external capital has become more difficult and more costly. There has been no shortage of bad news for investors in this sector. The electric industry competes broadly with other industries for capital from the investment community. We believe that these two concerns would tend to cause investors to redirect their investment dollars to other sectors and have a further negative impact on the ability of the industry to raise external capital and the cost of such

capital that's critical to finance the construction of new electric generation facilities.

Thank you.

MR. BARDEE: Thank you, Mr. Jacobs. Next is Gerald Norlander, Director of the Public Utility Law Project on behalf of the National Association of State Utility Consumer Advocates.

MR. NORLANDER: Good morning. Thank you for inviting us. NASUCA is an organization of more than 43 consumer advocates across the country, some in states of New York and the PJM areas that have restructured, and others from states that are still bundled up.

NASUCA last year adopted a resolution at its summer conference on market power. And we urged FERC at that point to expand its market power analysis and to take action to address the problem of market power in the new and changing electricity markets. We commend FERC for undertaking this move. We think it is appropriate and we think it is necessary.

This hasn't worked out as most people thought it would. Most people thought that we would be moving toward a more efficient, simpler mechanism in which largely private entities would compete with one another and drive prices down. Down from what? Down from the old paradigm in which they were entitled to receive rates that would yield enough

revenue to cover their variable costs plus a reasonable return on their equity. And the thinking was that everyone would be better all around if we could devolve that responsibility into the private sector.

I think it is significant that the entities that have been created to utilize a market-like mechanism for establishing prices, notably the New York ISO and PJM, have also supported FERC in this move. They too recognize the need for action. Likewise, the Northeast group of public utility commissioners, the Connecticut and New York Commissions, and prominent utilities, notably in Boston and New York City, also have supported the FERC action. Why? Because the results have not yielded just and reasonable rates. They have yielded rates far higher than we would have experienced under traditional regulation in some instances.

Each of the ISOs has recognized the existence of market power in the reports of their own market analysts and market monitors.

What are some of the remedies here? FERC we believe should order cost-based regulation when, or other appropriate means of mitigation in any wholesale market, when the rates are not demonstrably just and reasonable. Well, how will we know if they're just and reasonable? I think that one of the practical things I would like to leave

with you today -- and this is a recommendation coming from us -- is that the Commission at a minimum should be requiring bidders in the spot markets to provide contemporaneous cost data. It shouldn't be a discovery proceeding months or years after the fact. It should be filed with the bid. After all, these companies in theory are going to be bidding in their marginal costs.

I think one of the great contributions in this proceeding is the learned papers from the professors to show why generators don't want to bid in their running costs, why they think that there are many situations where it's reasonable not to. I think that certainly states that are considering adopting such a mechanism will be educated by these papers because I think a few years ago the thought was that we were going to get a simpler, not more complex behavior out of the generators.

If we don't have the data, it's like being weapons inspectors in Iraq with no Jeeps. You can't really determine or measure if things are better. And so I think sometimes the issue has shifted. Is this what we want? If FERC wants to have a better system, wants to achieve results better than cost-based regulation, results for whom? Results for consumers? We would hope so. And that would mean lower prices.

So I think that we need to be looking at costs so

that we can benchmark for each generator what their costs are. Now they would still be free to bid in above that but it would permit perhaps a market monitor to take a quick check and permit the development of mechanisms to handle the extraordinary bids that seem to be flagged when a generation is bidding above cost.

You've asked for a couple of things that -- of ideas here. I think that one thing that we are concerned about that's not on the list of examples of market power would be the problem that seems to have been observed in the literature and in experience of strategic bidding in the markets.

We apparently do not have enough participants in the markets, and the screens that have been used to give a green light for market-based rates have assumed that a much too small number of participants is enough. I think in particular the research of Professor Mount and some of the work that's been done in the academic realm on game theories suggests that the antitrust screens and the thought that people who have no more than 20 percent of the market share cannot exercise market power, that notion I think has been pretty well debunked.

And so I think that there needs to be much more attention to bidding behavior and in that sense, I think I'm in agreement with Mr. Harvey, where perhaps we need to take

another look at divestiture and mergers and consolidation in the markets. And I've already touched on the point of cost data. I think that's very important for FERC to be gathering.

I think I've covered my points. I just again want to conclude in saying we appreciate the effort that FERC is taking and look forward to further discussion about this this morning. Thank you.

MR. BARDEE: Thank you, Mr. Norlander. And finally is Robert O'Neil, counsel for the National Rural Electric Cooperative Association.

MR. O'NEIL: Good morning. I want to thank you for the opportunity to speak here. My name is Robert O'Neil and I'm a principal of the law firm of Miller Balis & O'Neil P.C. here in Washington, D.C. And I'm speaking on behalf of the National Rural Electric Cooperative Association, which is a national association representing distribution and generation and transmission cooperatives throughout the country.

Perhaps what is unique about the NRECA members as participants in the business is their primary concern is the delivered cost of power to consumers. I mean, those are the folks who own them. That's their objective.

I'd also like to add a little bit of my professional background, because I think it has some

relevance to the issues that are being discussed today. I'm a product of the regulatory environment. I have many years as a practitioner here before the FERC. Got involved in the policy debates in the '80s and spent times out in Keystone with Dick O'Neill late at night talking about economic theory and what have you. And it became apparent to me by the early '90s that deregulation was on the way, so I started advising my clients that it could be a bumpy road and to plan for it. Some of them did. We actually built power plants.

So I also have had the rather questionable joy of sitting across from bankers and negotiating \$100 million loans and spending four or five months in New York trying to close them and worrying about the construction process and getting the note of a force majeure claim because there was a train wreck where one of the turbine generators was hit by another train. I mean, all these joys from the trenches.

I represent clients who have market-based rate authority and in fact sell at market-based rates and are concerned about the recovery of the investment in their plants. They also represent consumers who are concerned about the price they pay. So there's a real balance of concern here.

I come here not as an economist, I guess as a practitioner who lives in the trenches and deals with the

real world. The real world has real problems. Example: In order to meet the power supply requirements of one of my clients, you have to meet not only your expected load but reserves. Now every year you're going to have one megawatt hour that represents your peak. If it costs \$54 a kilowatt year for capacity, your cost for that megawatt hour was \$54,000 a megawatt hour plus fuel. That's not the cost of your base load. That's not the cost of the intermediate.

When you look at pricing, one of the things you have to be very pragmatic about is looking at pricing over a temporal period. The other thing you have to be very concerned about is when you plan for meeting a power supply requirement, people typically plan for normal conditions and then they try to hedge against the abnormal conditions. It seems to me that what the Commission is proposing here is a form of a hedge. The Commission is not proposing to reregulate. The Commission is recognizing that there can be abnormal conditions. And just as a prudent transmission planner and just as a prudent power supply planner will try to take into account the unexpected and to provide some mitigative measures to deal with the unexpected, the Commission is doing the same thing.

Now the question is, how do structure your mitigation? How do you structure the mitigation so it doesn't do more harm than good? How do you structure the

mitigation so it's economic? It is not economic, for example, to put in perhaps a totally redundant generation step-up transformer, even though if you lose a generation step-up transformer, given construction cycles, it could be six months before you get a replacement. It is prudent to try to set up some sort of a pool and to construct a transformer that people could utilize as an emergency.

Here the Commission says, look. What happens if the promise of deregulation is not being realized because there is not a competitive market? What happens if the promise of deregulation is not realized because someone manipulates or abuses the market? Should we have the ability in those circumstances to take action to prevent injury to the consumer? Now the last I checked, Congress had not repealed the Federal Power Act. It's still on the books, still a consumer protection statute. The whole concept of deregulation is to enhance the opportunity for consumers to receive electricity at hopefully good prices, good services, et cetera, although the caution we all have to bear in mind is that electricity is a commodity unlike any other on the face on the earth.

And consequently, you have to be very, very careful about generic discussions about economic behavior of the commodities. Because I know -- not only do I know from my experience as a negotiator, I may be one of the few

Washington lawyers who actually sits on the operating committee of a power plant. There are realities regarding the generation of electricity that are just different. So the position of NRECA is that the Commission does -- is headed in the right direction, but there are some modifications that you ought to take in mind.

It is legitimate for a seller in the marketplace to be concerned about an open-ended refund exposure. But that can be address. Refund exposure per se is not an intolerable burden. I mean it's existed since 1935. But you have that exercised in a case where there's an expected end and people can book some sort of an allowance to deal with the potential for refund. It would be appropriate for the Commission to periodically, perhaps every six months, determine the markets are competitive. And if you make that finding, that can terminate the refund exposure.

And this is a proactive approach. This is not one in which we wait for a compliant because the other pragmatic problem is that many participants (a) don't have the data, and (b) as a practical matter, either lack the resources or might fear reprisals. If you are in a market that you have to pay a rate that reflects the ability of some entity to exercise market power over you, that may very well be a recurring phenomena, and there's a great deal of concern about throwing a rock at the guy.

The Commission should take a more active role in that regard. The Commission should also look not at a single hour, perhaps; you should look at perhaps a block. As some people have noted, it may very well be that you will enter into a transaction where you will have a cost profile that extends over many hours. You might actually be selling at a loss. Then, as a practical matter, you're going to try to recoup the total cost within a particular hour or series of hours.

The Commission implicitly recognized this when it modified its fuel clause regulations many years ago, when it modified Order 517 to deal with economy energy purchases, not on a hour-by-hour dispatch analysis but instead looking over a transaction period.

The final point I'd like to make is that I don't think anybody's got it right yet in terms of market structure. I don't think anybody professes that they have it right yet. This is a learning process. If the public loses confidence in this process, what the industry will be facing is not the Commission proposing to impart some degree or some measure of refund authority to deal with market aberrations or market abuse, but you're going to be facing a political push to prohibit market-based rates and to basically mandate re-regulation. So I would suggest that everybody, particularly those people who want to participate

in this market on a competitive basis bear in mind that having something like a pressure relief valve that the Commission seems to be taking about here may actually be very, very beneficial to them.

Thank you.

MR. BARDEE: Thank you, Mr. O'Neil. With that, I'll turn it over to Staff for any questions.

MR. PEDERSON: I think where we probably would like to start in this discussion is in the Order itself. There was a lot of concern we heard this morning as well over the examples the Commission had put out there in the order. The order talked about physical and economic withholding. It also talked about barriers to entry. We'd like to talk a little bit about those definitions and also other examples that you might have that need to go into there, into the order, into the tariff, in terms of getting some certainty. So if we could hear some feedback on the definitions themselves.

MR. CADWALLADER: I think with regard to your definitions of economic and physical withholding, I agree those are good definitions. I would like to add, with regard to economic withholding, that that can occur even if a unit is selected but sets the marginal clearing price in the market. Because in that case, the market price has been raised but under definition that currently the Commission

has out there, it would not constitute prohibited behavior, so we'd like to see that particular aspect changed. I think with regard to other things that can be done in the marketplace to manipulate prices, I think with regard to the supply side of the equation, the Commission has pretty well covered everything I can think about.

With regard to the demand side, I can see instances where demand is wasted, and by that I mean a supplier would provide power to a particular user under contract and that user would be dumping the power either by burning it frivolously or some other mechanism. While that may be a small concern and an unlikely situation, I can see that as a possibility.

MR. LARCAMP: I'm interested in some pragmatic advice for the Commission and its Staff as we go forward with trying to measure instances of bad behavior, and we can call it physical or economic. Looking just at Connecticut, do you have any idea what percentage of the generation fleet in Connecticut is not energy limited so that when we're trying to gauge whether action in Connecticut is or is not an appropriate bidding behavior, the nuclears run of river hydro, everything else I assume is energy limited.

MR. CADWALLADER: I think with regard to Connecticut, we were part of the New England ISO so we're really part of the New England region with regard to the

prices that we're seeing in Connecticut. There isn't a lot of hydro in Connecticut and I believe in New England in general. My understanding is that those are the primary instances where you have limited resource generators. The other side of the equation is the economic limitations and we are in an ozone-constrained area in Connecticut, but those limitations also come into play.

I think with regard to those particular resources that are limited with regard to how often they can run, you really have to consider opportunity costs in those instances. That has to be part of the equation.

MR. LARCAMP: I'm asking for pragmatic help on how we measure whether someone's bid does nor does not reflect its opportunity cost for a particular hour. I heard one thing do an assessment of the markets every six months, and if you determine that it's competitive, candidly I think we have a confidence problem here with American customers. We have a confidence problem with state regulators. We have a confidence problem with the consumer advocates that represent American customers. And we need to be able to articulate why price in a particular hour is a legitimate price even though it may be higher than an average embedded price, and I need some real world help from you people about how we're going to measure that. Because if the discussion stays academic at 50,000 feet, it's not very helpful to

people who are sitting around this table. I think we've taken the criticisms and we find many of them legitimate and now we're trying to decide how can we modify this in a way that will in fact instill confidence in the competitive solution this industry.

MR. CADWALLADER: I think you really have to look at marginal costs. The difficulty is looking at opportunity costs and in that case you have to look what is the likelihood that these limited run generations can sell power in other hours for more than is being offered in a particular hour. So it becomes a comparison of market prices across time when you're looking at those particular resources. I think with regard to any resource that's bidding, you have to look at is this resource bidding so as to maximize the value of that particular resource?

MR. O'NEIL: Steve, let me clarify. Do you have a trading system for ozone emissions and NOx emissions in Connecticut, or is it just restrictions on the generator?

MR. CADWALLADER: There's a restriction on how many hours they can run normally is the case based on the kind of fuel they're using.

MR. O'NEIL: Hours per month?

MR. CADWALLADER: Hours per month, hours per year, hours per season. I think to try and get it as specific as possible, you need cost data. You need to know

what the marginal costs are of the various units, and when we're talking about \$1000 per megawatt prices, and Scott's talking about shortages, I think we have to be careful because a shortage to me is when you're running out of supply, you're out of supply and you actually have to try and shed load or find other ways to decrease demand. And those situations, it is my understanding, are very rare.

What we're usually looking at is a situation where supply is getting tight and in those situations you're still looking at marginal costs of supply options that haven't been utilized yet. So I think we need to be careful when we throw out shortage versus scarcity, because I think that's a problem.

MR. BARDEE: Let me ask a little more concretely, and maybe Julie and Scott, if this is where you're addressing your comments, good; if not, feel free to chime in Dan's question on the opportunity costs. Suppose we modify this condition to allow recognition of an opportunity cost principle. I can understand geographically you're in PJM but the prices outside on a given day are higher and you want to sell outside. That's pretty verifiable. You can document what the price outside was.

But suppose you were in springtime? The loads pretty low, and you're keeping stuff off the market because you say you want to save it for summer. How are we supposed

to verify that? What's our documentation that we can rely on to say that that was legitimate?

MR. HARVEY: I think actually the verification, if you're selling it in other areas it's very easy. You don't need to withhold because in either PJM or New York they can put in a bid regardless of how they built their plants. They can bid to buy energy from the spot market so they don't need to distort the bids for their plants.

But when you get to hydro and energy-limited units, I think it is very hard. That's what I've been saying. This is non-trivial step. I thought about this and I don't have any magic bullet. It's not just the tradeoff between energy today and energy in another month. It might be, if I use up too much energy today, I can't provide reserves for the next two weeks. Therefore, I lose a lot. And some plants, some of the hydro systems, have operating characteristics, or if you lose too much now, you lose more than that for the next few weeks. That's where you need a detailed inquiry that would be pretty scary unless you have some way of limiting it. Now that's just from a pump storage and hydro units. And then for the energy limited gas units, you have the same issue.

But I don't have, I mean, an easy answer for you. That's why I said it's a big bridge to cross. Then you get into units that have operating problems. Again the only way

to resolve that is to look at the operating records of the plant and say, is it reasonable or not; I don't have, I'm not going to tell you that that's likely to be a pretty inquiry, figuring out why a plant decided not to run their jet capacity one day, or did run it at another, and the different operating states it was in. You know, that's why I was encouraging you to try to find a way, you're only looking at the outrageous behavior and not every nickel and dime, because it's going to be pretty bad.

I also want to seriously disagree with this issue about we're only in a shortage when the lights go out. The reality is if everybody bids their products into the New York ISO at cost, and we don't have enough to meet our 30-minute reserve margin, we might have enough to meet all but five megawatts internally, but if we have to go out and buy five megawatts at a thousand bucks, or if we have to tap the cogen units shutdown production lines to free up energy for us, that sets the price at a thousand bucks.

The ISO right now cannot say, I'm going to without some of those reserves. They're going to pay, and the operators will tell you I feel I have to go out under the reliability standards and pay a thousand bucks for that last megawatt of reserves even though I'm not going to have to shed load because if something bad happens, I'm very exposed.

MS. SIMON: I appreciate the frustration and I appreciate the interest in trying to pin this thing down.

But I think we are chasing down the wrong path here and we need to be clear on what our goals are. If the goal is to restore consumer confidence in these markets, we need to look at what are the steps to accomplish that goal. Going back to cost-of-service regulation and second-guessing transactions on a transaction-by-transaction, hour-by-hour basis is not going to get us there. It's very important, as I mentioned earlier, that we not pick a cure that's worse than the disease.

We have a situation where there are a number of price signals that get sent when prices are high. The example that I love to use is the midwest from a few summers ago when this Commission took no action, those costs, those prices, those \$6,000 prices were not cost-based but they brought in an enormous amount of new investment into that region and have kept prices low ever since. So the real question in my mind at least is how do we encourage the industry to develop appropriate hedging mechanisms. Bob O'Neil is absolutely right.

This is a regulatory hedge. Is that how we want competitive markets to function? Or do we want competitive markets to develop the type of hedging products that allow people to manage risk? The only time consumers see

extraordinarily high prices is when, for a variety of reasons, people haven't hedged properly, and there's no reason for people to be in these markets without hedging. There is a huge variety of products that are offered and if people want to gamble that prices aren't going to get high, that's fine. But when they pass those costs to the consumer, that's a problem, that's a whole different set of problems. That has to do with the design of the retail programs at the state level, it has to do with what state commissions allow utilities to do, and at what point these costs are passed through the way fuel adjustments are passed through. But it isn't acceptable for people who choose not to hedge to then come to this Commission and say, save me.

There's another aspect of this that I think we're all missing in this discussion that I strongly urge you to keep in mind. That is that we have developed over the past several years, a very robust industry in power marketing. The marketers bring enormous value. They allow people to manage risk. They offer an array of products that let people buy the services that they want. They match buyers and sellers and the more we tighten the cost-based system, the less we're going to permit that entire industry to participate, and if we lose the value that marketing brings to this industry, we will have lost a lot.

So I understand the frustration and the desire to

know that each transaction is somehow okay. But we have to move away from that and look much at the big picture at what are the steps to take. If we look over any period of time, customers are paying less for electricity now than they were. Whether or not we can always ensure that the competition lowers prices, that's ridiculous. There will be times when prices rise, and they rise for a reason, to send price signals.

Will they be lower than they would have been in a less efficient system? Absolutely. But we can't take our eyes off the goal here.

MR. HILKE: Part of the picture Scott was painting is how difficult this could be. Part of the picture I want to paint for you is basically how detailed this kind of inquiry can get. If you're asserting that somebody has exercised market power and their defense is this is a way we need to operate the plant to provide the optimal reliability from that plant, you get into a situation where you have to basically subpoena all their records, but not just their operating records. It's their strategy records, it's their marketing records. And you're going out and deposing basically everybody to try to unearth the truth. This rapidly blooms into a very complex litigation which takes a long, long time to accomplish. By the time you reach some resolution to that, the cow is long

out of the barn.

MR. McLAUGHLIN: Julie and John, here's the way I see the problem or the issue we're trying to grapple with. That is right now our analysis is on a company-by-company, at least in those non-structured energy markets. It's on a company-by-company basis where we look at the lack of generation dominance. So we haven't made market power determinations. We haven't determined the market's competitive; we've determined that somebody lacks generation dominance. Within that framework, we're working on structural solutions, we're analyzing those now. But we're trying also to look at an internal approach for this summer.

Let me just put into the context of this summer. What I'm hearing is in effect it's best to do nothing and let the market play out until we get structural solutions in place because the complexity of trying to address these internal problems is, in a sense, going to do more damage than good. It's not worth our effort.

Is that the message you're trying to tell me?

MR. HILKE: The problem is that your screen, as you say, has not been doing what it's advertised to do. And the question then should be how do you improve the screen as your first criterion. And structural fixes are the logical way to address situations where it doesn't look as if the screen has been affected in the past. All I'm saying is

that there are high costs to taking the behavioral approach. To the extent that you're forced down that way, I'm just urging you to do it with your eyes open. I don't know what the tradeoff is between the costs and benefits. That's something you have to assess. But what I'm telling you is that the costs of the behavioral approach can really be quite considerable, and from the paper I've seen, you know, before it didn't appear that your eyes were wide open. So I'm encouraging you to open your eyes.

MR. O'NEILL: There's a very important question. What do we do this summer? We're not going to get divestiture, we're not going to get entry. Would you outlaw the unilateral exercise of market power? If so, how would you enforce it?

MS. SIMON: Let me try to be practical for this summer, okay. The exercise of market power isn't legal right now. We're not talking about something that people are permitted to do. They're routinely meeting on Thursday down at the bar.

MR. O'NEILL: We're not talking about collusion, unilateral exercise of market power.

MS. SIMON: The problem is that there is no evidence that that is widespread in today's markets. What we need to focus on is what the immediate problems are, and in our little leave-behind, we have some suggestions. Let

me lay them on the table.

If we're concerned about volatility, the kind of needle price spikes we have seen in some of these markets in the past, let's talk about a bid cap. We currently have \$1000 bid cap only in the New York ISO markets. It's possible to impose that on a nationwide basis as a substitute for demand response. It is not what it costs to get demand off the system, but let us assume for the sake of a short term discussion that we could put something like that in place on a short-term basis. Let's look at some of the other things that are creating problems on the system right now. ATC calculation is a serious problem. We know that it has created a host of market disruptions.

Two years ago, you asked for ideas of how to solve some of these problems on an interim basis. We suggested in the absence of RTOs that you have independent calculation of ATC. That's something that could be done this summer. We suggested OASIS audits. That is something that could be done this summer.

The Commission has suggested and put in place in other instances, a host of very-short term measures to allow extra megawatts to get on the grid to solve the potential for tight supplies. Implement those again. Allow on-site generation and self-generation to bid at market-based rates. All that demand response which can reach the market to enter

the market. It's not an either/or. It's not no demand that can be in the market. There are complicated jurisdiction issues in some areas but not everywhere. If the issue is what to do for this summer, then we need to look at what things can be done easily, can be done quickly, and can be done efficiently.

Separate from that, we have a procedure on-going in the standard market design and we need to look at these issues very, very carefully. There may be something below the \$1000 price cap that is doable, but we're not going to come up with it just shooting from the hip and throwing out ideas. They need to be understood, they need to be modeled. We need to know what we're getting into.

One of the commenters in this proceeding suggested a high bid cap with a capacity market. I don't know how you're going to get a capacity market by this summer. It's March already and the high prices generally come in May. I think we need to be realistic about the steps that can be taken in the time that we have available to us.

MR. O'NEILL: Julie, I agree with everything you said, but do you believe we should make the unilateral exercise of market power illegal?

MS. SIMON: I think where people have been found to exercise market power, this Commission has been able to

remedy that situation.

MR. O'NEILL: Should we make it illegal?

MS. SIMON: I don't know what means. I don't think we want --

MR. O'NEILL: If you don't make it illegal, you can't prosecute it.

MS. MARLETTE: Can I jump in? I think what Dick is saying, exercises of significant market power are illegal as we speak. If somebody walks in the door today with a complaint or the Commission gets other evidence that a particular seller may have engaged in market power, we can look at it. The same Pandora's Box opens. The same difficulties that John has raised of trying to figure out what was or wasn't an exercise of market power that requires regulatory prevention is still there. The difference is we cannot remedy retroactively. We have to come up with a remedy that can only go back as of the refund effective date. That's how we got into putting this condition into the tariff in the first place, so all these horrors are still there, and there are uncertainties.

What we're facing with this condition is potentially going back. We put no limit, not box around how far back in time we could go. So I guess I see some of these arguments as here, or potentially here, whether or not we put this condition in. So my question to you is, if we

were to continue with the type of condition, are there procedural limitations that we could put in place that would give more -- I hate to use the word "comfort" -- nothing would give you comfort but would result in less uncertainty to the industry, at least until we can get the structural remedies in place for the RTOs, the standard market design, whatever market screen we're going to have in place, and frankly I think that all of this may take longer than this summer to actually get in place, but are there procedural boundaries we could put around this to provide less uncertainty?

MS. SIMON: Realistically, I think you probably will face litigation over this if you implement it. I think that in reading through the comments that have been filed, there are significant legal questions about your ability to override the Federal Power Act. I'm not a practicing lawyer.

MR. LARCAMP: Very little we do around here doesn't face litigation risk, Julie.

(Laughter.)

MR. LARCAMP: That does not particularly concern us on this side of the table.

MS. MARLETTE: Keep in mind, this condition is in the Western Sellers tariffs now. It didn't cause the outcry when we imposed it about a year ago, so we still have that

in place, and we still face legal arguments there, but I would rather stay away from the legal and look more at the practical.

MR. O'NEIL: I just I really hate what I have to say, and I agree with you and that's wonderful, but you misunderstood me.

(Laughter.)

MR. O'NEIL: When I was making reference to hedges, I was not talking about hedges against the high prices that might occur in the competitive market. I was talking about a hedge when you don't have competitive markets because I think that's what the Commission is talking about. We're not talking about a situation where market forces are operating in such a way that there happens to be a scarcity price or what-have-you. I think as I understood what the Commission was saying, look, if we don't have the basic deal, the basic premise for the market-based rate authority in the first instance, which is a competitive market, or if we have abuse, those are the circumstances we step in. How do you identify what those circumstances are as a pragmatic way. If you're talking about, let's say, manipulation, there are a couple of ways, infinite ways I guess you could have manipulation. One classic example would be someone who both has power plants and a trading organization knows that if a particular unit of capacity

goes off line, there will be a reaction in the spot market.

They know it, it happens. They take forward positions.

Lo and behold they've got a plant that has a tube leak. It comes down off line, and price goes up. They lost some money on the sale from that power plant. They made a killing in the market. They know that the plants coming back on line before everybody else; they take different positions in the market. They bring the plant up, it affects the price.

So one question is should there be reporting when there are circumstances or events, such as the unexpected operation of a plant. When I say unexpected operation of a plant, if someone puts in a peaker that's NO_x-limited on the amount of hours it can generate, the typical market they're probably looking for is a summer peaking market, so there shouldn't be a particular surprise if it doesn't the market- in October or what-have-you to bid.

If someone builds a baseload plant and the expectation and the economic justification of that plant is a 90 percent plant factor and all of a sudden, it's going to about a 60 percent plant factor. And mind you, if you have access to the data to show that affiliates are making money, as opposed to losing money, as a result of this plant coming off line, there may be some indication of something afoot.

Intermediate plants, what his the normal

operation? Query: If you're going to talk about reliability and having some degree of reliability, wouldn't it be inappropriate for generators to report to the FERC, or someone else, what they're expected operating profile is? In other words, here's how we expect to operate this plant. This is a peaking plant. We're not going to have the thing mothballed during the winter time or what-have-you, and you look for the aberrations.

Again, all we're talking about here is circumstances where you have evidence that causes you to believe that the market wasn't competitive. The exposure that's faced in refund on a traditional refund is a just and reasonable rate. The Commission has in the past opted not to require refunds. The Commission has opted not to give interest on refunds. So the real fear here it seems to me is that that Commission will be abusive in its exercise of what appears to be a very limited proposed amount of power. Me thinks they doth protest too much.

MS. SIMON: Cynthia, in the comments we filed, we suggested a number of very specific ideas that if the Commission goes down this path, this is not something that we're obviously endorsing, and I want to make that very clear in any statements I make today. I have a room full of members here and the first thing we suggested was that if anybody challenges a transaction, they have the

burden of showing that the transaction was not just and reasonable, so it's not a presumption in other direction.

The second thing was we suggested a time frame of 30 days to challenge any transaction. We also suggested that the Commission act on it after the party has an opportunity to reply, that the Commission act in a similarly tight time frame. The concept of transactional finality is critical. So we need to have complaints brought quickly and resolution brought quickly. That obviously is of great importance if we go down this path which, for a variety of reasons, we don't think is the right thing to do.

The other thing we suggested is excluding bilateral contracts since those represent decisions by sophisticated parties in the wholesale market to come together to manage risk in a variety of ways and to begin second-guessing those types of contracts is definitely a direction that would open a huge Pandora's Box of problems for the Commission.

The problem is that the rest of the country operates either, in the short term at least if we're talking through this summer, through the mitigation that takes place in the west. I'd hate to see any more litigation over prices in the west, given the intensity of the Commission's involvement in those prices already. And the fact that the only organized spot markets are already functioning, run by

RTOs with the type of market monitoring and the type of oversight and reporting that you already get. The problem is that doesn't leave any place to implement this because the other markets are the bilaterals.

The problem is that I've sort of circled back to suggesting I don't know what problem it is that you're actually trying to fix with this refund conditioning at least in the immediate term. That's where I keep coming back to suggesting that we'd be better off spending our time looking at the kinds of things we need to put in place to restore consumer confidence and make these markets work in the short term.

MR. CADWALLADER: I wanted to address Julie's suggestion that we use a 30-day limitation. I strongly believe that's much too short a time to have for people to challenge market prices. We have breach of contract limitations that run six years in Connecticut and there are contracts of similar length in other parts of the country. I'm thinking in terms of an order of magnitude if we're looking at that kind of time frame, perhaps to years may be sufficient, particularly as the Commission and others get used to administering these kinds of reviews of the market to see if in fact economic and physical withholding has taken place.

Also I'd like to stress the concern that this is an extremely difficult undertaking to undertake. There needs to be a lot of thought and careful consideration as to what are the appropriate opportunity costs and what are the appropriate marginal costs. But I think we only need to do that once. We're not going to have to reinvent the wheel every time. Once we have those things in place, it becomes a fairly easy matter to administer it as we see it happening again and again and again as I think it will be until people get the message that if you engage in market power and anticompetitive behavior, you will be found out and you will be prosecuted.

I think that's the message we need to send. I don't think it is an insurmountable difficulty.

MR. NORLANDER: I'd like to try to address the issue of this summer. I think certainly in the New York City area, no one can predict with any certitude what will happen this summer. It will depend on heat, recovery of the infrastructure and a number of other factors. But from past filings, Con Edison has reported that at times it buys from two or three people. I think therefore we need to look at how that market is working, and I don't think it's a market.

What we need to do I think is have perhaps filing and publication even of both bid and cost data and then in the realm of prophylactic measures, generators will think

twice before going that 1,000 or 100. That's one potential remedy. Because I do think playing catch-up and trying to go at individual cases of behavior is certainly not desirable but may be necessary. But if we can prevent it by curbing unreasonable bidding behavior, then I think that's to be preferred, and we should try to think of ways that will encourage the bidders to do what in a truly competitive market they would do.

I think there's another issue that's been troubling me. That is the problem of natural gas. If the units that are snagging the market clearing price on any given day are burning gas and if there's a Nash equilibrium afoot in these small markets of a handful or so or maybe more, at least those units that are likely to clear the market on a particular day, does any of them have an incentive to put in anything other than the spot market of gas if indeed the spot market is moving up at that time? Even if they hold gas supplies at a lower cost.

And so that may be perhaps the opportunity cost we're really talking about here that someone would say, well, gee, the day before the day before, I could have sold all my gas in the spot market and made a lot more and bought it back on the day I'm bidding in, or timed it in such a way. And as long as his neighbors are doing the same, they'll maintain the same pecking order, and they'll all run

in the same order they would have run pretty much if they'd all had a different gas portfolio. They learn over time that they're all pretty much better off if they all do this without over-collusion, without going golfing, without going to conferences and mentioning that, gee, why wouldn't we put in the marginal cost of gas? Even, you know, if we have a supply that's cheaper.

So there may be -- I don't know if that fits in opportunity costs so much as opportunity in another market to use their fuel. I think that some of the examples of opportunity costs are really more in the nature of withholding. The hydro plant that can run only a certain number of hours is really withholding, they're not -- and I think the notion of opportunity costs is a decisional factor for the person who decides whether to run or not. But the market should still encourage that bidder at the end of the stack to be bidding in their marginal cost, the best we can encourage it. So it may be that for a period of time we have to have transparency in posting of what the price, what bid and cost was.

MR. LARCAMP: I'd like to encourage you all to get back to the notice on the purpose of this conference. I think a lot of these are excellent comments for standard market design and market monitoring in general. But the purpose of this conference is to sort of focus on, I've

heard some people say we like the condition as is. Other people say get rid of the condition. I think that's what Julie is saying. Are there modifications to the condition? We'd like to know before you leave in 35 minutes or so, are there specific modifications to the condition that you think are appropriate in the interim? Leaving aside sort of general market monitoring, standard market design issues.

MR. HARVEY: In terms of there's something that you're changing fundamentally here when you say we're going to impose the refund condition first, which is that if I'm a fringe player and you impose the refund condition on me, even though I haven't been doing anything, I have to worry every time I see a high price in the market. If I respond to that, am I going to get burned when you later change that price on me?

One question which I recommended is that if you don't apply the refund condition to anybody other than the entity that exercised market power. In other words, if Dick withholds his output from the market and I happen to increase my output, I benefit from the high price. But it's people like me that will keep him from doing it. That is a difference that if you impose this refund condition on everybody, you actually may find that you have more high prices because some people won't respond the way they did in the past.

MS. MARLETTE: The condition was crafted to be seller specific.

MR. HARVEY: That wasn't clear in some of the discussions. If this only applies to the refund condition only applies to the specific entity that exercised market power and you don't go back and revisit what the price of every spot price and contract and everything would have been, that would be one improvement. Maybe that's what you always intended, but that wasn't clear to me.

MR. LARCAMP: Does everybody agree with that?

MR. CADWALLADER: Yes.

MR. O'NEIL: No.

(Laughter.)

MR. NORLANDER: No.

MR. HILKE: Pass.

MR. O'NEIL: The question is whether or not there'd be basically third party beneficiaries of market power. That's the issue. And if the point of market-based rate authority is that someone can charge the rate because the discipline is imposed by a competitive market, I don't think that they say, well, I'm not the guy who broke the lock on the door. It was open. I walked in.

I don't think that gets at the core issue of establishing and maintaining the credibility from a consumer standpoint that a market-based rate is not a license to

steal. It is disciplined by competitive markets.

MR. CADWALLADER: I guess I'm looking at a situation where you have a centrally dispatched market and somebody has withheld output, and because of that, the market price goes up higher than it would otherwise be, and people sell into the market by bidding appropriately and happen to get a higher price. In that instance, I think you go out to the guy who withheld the output and only him, because otherwise I think you have a serious problem with disrupting the entire marketplace and the ability to rely on the prices that the market sees.

MR. O'NEIL: How are you going to ask the guy who withheld the output to refund anything? There's no remedy there.

MR. CADWALLADER: I think you have the basis for saying he owes the incremental cost that you raised the market price to everybody that incurred that additional cost, and that can be an extremely severe refund penalty. And I'd like to add that you've got to penalize the perpetrator more than just his incremental benefit from doing the action. Because if you're only taking away his incremental benefit, you're not giving disincentives to engage in the behavior.

MR. O'NEILL: You raise a very interesting point. The penalties could be very severe in that situation where

you try to remedy the problem ex post. In New York and some of the other ISOs there are ex ante remedies. Is an ex ante remedy, although it's prone to errors, better than ex post remedies?

MR. CADWALLADER: I think you need them both. If somebody is manipulating the market, you can put in some ex ante restrictions on him, but I think you also need to reach back and penalize his actions from his historical deeds.

MR. O'NEILL: Scott, you're a scholar of the New York ISO.

MR. HARVEY: Well, it's better to, if you've got a market power problem, it's better to mitigate it and then everybody responds to those prices rather than changing them after the fact. Because it may be if you're going to change the prices, then your analysis of withholding has to factor in, well, now I'm thinking that maybe you're going to change the prices so I don't increase my output and it's not withholding. It's anticipating what you're going to do.

The strength of the competition is all the small people increasing output. So if we penalize them, we are going to get high prices. We're going to get higher prices despite our mitigation, because they won't bring in supplies from outside the region. They won't do the crazy things that you would expect them to do to increase output.

MR. O'NEILL: Are you saying your preference is

for ex ante mitigation than ex post?

MR. HARVEY: Right. And the most ex ante, of course, is divesting the generation in the first place.

MR. O'NEILL: We all genuflect at that altar.

(Laughter.)

MR. O'NEILL: John?

MR. HILKE: I agree.

MR. NORLANDER: Excuse me. I just wanted to say I think, again, ex ante is to be preferred. But we should note that the New York ISO does have an automatic mitigation procedure that basically captures a bidder who is moving a bid up in relation to the prior bid behavior in the prior 90 days of his own behavior. And that I think was a step in the right direction but it didn't cure the problem, and I think that's why we need the condition. And perhaps we need a way for these, if we're going to have these markets, to empower them or their monitor to do a fast reset. You know, you can have your ex ante remedies. There even may need to be a quick reset based upon, you know, a short period of time. And then more protracted issues being brought here I think either by aggrieved parties or by petition to deal with perhaps extreme cases of withholding or overbidding.

MR. O'NEILL: Julie, do you have any feelings?

Ex ante versus ex post?

MR. LARCAMP: She has feelings, Dick. Come on.

(Laughter.)

MS. SIMON: Obviously we want a situation where people know what the rules are, they play by the rules and there's finality to transactions so that we avoid the uncertainty that the kind of ex post remedies develop. I thought everybody would assume that. I'm sorry, I should have raised my hand.

MR. NORLANDER: Just one quick thing. If we knew what the marginal cost was of that market clearing unit, if there had been some pro forma or some other -- some knowledge of that, the market would know what the fallback price might be, what the reset price might be.

MR. LARCAMP: But the marginal cost includes the opportunity cost for the energy limited unit, and we won't know what that is. Is that what I'm hearing? I mean, I know that we can understand the marginal cost of each of the generating units in a particular region.

MR. HARVEY: You could say, and I was going to continue, one thing you could do to make it less impossible to implement is say we're not going to try to apply this to hydro units. We're going to say hydro pump storage, we know it's too complicated, you know, we're going to rely on other mechanisms to deal with competition there.

If you've got units, the gas and oil units that have got so many hours of run time per year and you've got

the potential of blacking out the city if you run them in the spring and don't have it in the summer, then you're not going to apply it to those units. You're going to say, okay. That's another problem. It's too complicated. We're not going to apply the standard to them. And you could say we're not going to apply to the Scott Harvey genco, which is his kids peddling a bicycle and drinking Coke. It's got to happen to a tenth of a megawatt. It isn't going to set price. We're not going to, you know -- have a de minimis standard. We're not going to mess around with people that are that small.

Look at cogen plants. Basically they produce output by shutting down a production line so they got more electricity. Don't apply it to them. Those are the things you could do to make this -- and only look at units that aren't, you know, if you're running in real time and all your capacity is providing reserves, regulation, energy and AGC in real time, regardless of what you bid day ahead, you're okay. I mean, those would make it simpler. But as I said, there's still going to be problems, especially on D rates.

MR. LARCAMP: Would we apply it to cogen that have the output above the useful thermal output? I mean, that's a pretty lax standard in our QF regs, so that there's a lot of output that's really not tied to the line, if you

will?

MR. HARVEY: Well, a lot of them, it is already sold forward. And what they're bidding in is the part that they can do other things and produce it. Because a lot of them are still under old QF contracts. But, I mean, if they were such a large entity that they had a lot of discretionary energy that they could produce or not, then you should be reasonable and apply it to them. But I'm thinking of the more typical case where basically they're must run for a bunch of megawatts, and they can help you out a little bit at the margin.

MR. O'NEILL: Steve, has Connecticut considered going to a trading system for their commissions limitations which would get you around some of this?

MR. CADWALLADER: Yes. Certainly we've encouraged the companies and the units that have those limitations to see what they can do to get either allowances from the Department of Energy to run more, or else to trade and offset with other plants. But I'm not sure how developed that process is yet.

MR. O'NEILL: That problem gets a lot easier if you have a trading system.

MR. CADWALLADER: Right. Right. And certainly it makes it more economic to do that.

MR. LARCAMP: Scott, do you have just an

arbitrary number for what that cutoff should be?

MR. HARVEY: Well, David Patten had tossed out 50 megawatts, which seems reasonable to me. I think it can be higher than that. If it's somewhere between 50 and 100 I think you ought to say these people are too small. This isn't market power. This is other stuff.

I thought there was a telling comment here. Well, maybe they didn't benefit from withholding output. But I mean then it can't be market power. Because if I don't operate but I also don't have any output in the market and I didn't make any money, then it must be something else.

MR. LARCAMP: And that would be you or your affiliates don't own more than 50 in the market?

MR. HARVEY: Yes. You've got to look behind the corporate veil. The ultimate parent entity is the antitrust jargon.

MR. BARDEE: Steve, I just had a question going back to what you all were just talking about in terms of the environmentally constrained capacity. Do you have a sense percentagewise or any other way of how much of the capacity, either in Connecticut or New England, is like that?

MR. CADWALLADER: I don't have a number offhand. Certainly there are a number of fairly large baseload units in Connecticut, maybe 1,000 megawatts total that have that

constraint. So it's not insignificant.

MS. LEAHY: I'd like to check, if we could go to the other issue, the process issue, the procedure issue. We've heard from a couple of the panelists in terms of what might be a reasonable time period within which to expect that a complaint would be filed if it's tied to a specific transaction, and I'd like to hear what some of the other panelists' thoughts are on that before we close here.

We've heard 30 days. Julie proposed 30 days, and I believe that Steve proposed two years.

MR. O'NEIL: NRECA would suggest a slightly different variation, which was the six-month review, where FERC would take a look at it and basically say that the market is all right, and that would effectively close it off.

Now that has to do with not a statute of limitations on someone filing a complaint. That has to do with an affirmative determination that would simply close out the books.

MR. CADWALLADER: I'd like to add to that a little bit. I'm intrigued by that concept that there be some sort of review that would look at a particular period and give a signoff on that particular period. And I think that's a situation that may be handled by an RTO or an ISO or someone who has been monitoring the markets day by day by

day and has the kind of data that they can make that determination.

My guess is you probably won't get a clean signoff on any particular period for everybody involved in the marketplace. And so you might put people on notice that their rates are subject to review or refund.

MR. O'NEIL: Another possibility in terms of the practical, what do you do next summer? Bear in mind that the existence of the condition in itself could encourage forbearance, even in situations where there are folks with market power. And the other question would be whether not you would have a situation where if the concern is, where is my exposure in terms of actual refund, give perhaps generators the opportunity to try to get some sort of a preapproval of a base amount that as long as they're not charging more than that, they're clear.

MR. O'NEILL: Can I switch the topic a little bit and ask some of the folks who are sort of close to the demand why we have been talking about demand response for years and don't seem to have any?

MR. CADWALLADER: I think, at least in Connecticut, we've been working on conservation for years and years even before restructuring. And I think the problem is there are relatively few customers that actually can change demand significantly on notice. And I think

that's part of the problem.

And the other problem I think particularly with restructuring is there hasn't been a well organized demand side of the equation looking at trying to have customers that can switch on and off.

MR. O'NEILL: Do you think state regulation may have caused part of the problem with demand response?

MR. CADWALLADER: I think the fact that customers don't see the prices that are out there in the market has a significant problem.

MR. O'NEILL: You can see the price in New England by going to the New England Web site I think, right?

MR. CADWALLADER: Right. But a lot of the customers aren't feeling that price. They're not paying that price.

MR. O'NEILL: Right. Because they have different state rate designs?

MR. CADWALLADER: That's right. And that's part of the problem. I think the way to get around that is to have some way in which you're paying customers to cut demand. But I think a lot more can be done on the demand side of the equation, and I'd like to see that happen. Because I think if we do get demand side response, that goes a long way to curbing market power.

MR. JACOBS: If I could, I wanted to weigh back

in here with the perspective of the financial markets. And I think one of the things I want to make sure that you all have a good appreciation for is how difficult a time that companies in this industry I think are going to have raising capital on a go forward basis.

With the changing credit conditions, with the dramatic decline in equity valuations that we've seen, raising money to build power plants is not a given. And I think it's highly unlikely that we're going to go back to an environment like we had 12 months ago where raising capital was very, very easy for these companies to do to build plants.

I think in terms of some of the things you're thinking about to modify the economic withholding concept, I think from a financial market perspective, that concept, regardless of modifications you may make, will be viewed very negatively by the markets. And I think if you look at any capital intensive industry, you can look at airlines or whatever, companies that are forced to price on marginal costs in capital intensive industries historically have earned very poor returns. And I think the financial markets will see that.

And if there's a concept out there that's floated that as a merchant generator, your returns are going to be tied to marginal prices, therefore your ability to recoup

fixed cost, not only fixed cost, but earn a rate of return on that investment, is going to be more limited. I think the financial markets are going to have a very difficult time providing money to these entities to build new power plants.

MR. LARCAMP: Have any of them talked about financing on a cost basis by -- any of the new plants talked about taking some of that risk away by selling their output under a cost-based rate?

MR. JACOBS: Not that I'm aware of.

MS. SIMON: I want to raise an issue. I want to go back to a concept that when we keep talking about his marginal cost issue, one of the issues that the staff put on the table earlier and we really haven't spent any time talking about is whether or not every megawatt is fungible with every other megawatt.

And I think it's very important to realize is that markets not only need a variety of product, you know, in terms of reserves and different types of reserves and so forth, but also that peaking units provide a very different role in the marketplace. And one of the real concerns with the mitigation in California, and I would hate to see it translated across the country, is that we send a signal only to build baseload units.

We need black start. We need quick start. We

need peakers. We need a variety of different products and at least initially, a number of the cancellations in California were in fact the peakers. And I would hate to see a marginal cost-based approach here carry that forward. We don't need to just have baseload plants running all the time. We need to be able to respond with a variety of products on our side of the business which need very, very different price signals than baseload units.

And so if we're going to talk about different types of exclusions, we may need to talk about different tiering as well so that the plants that need the very high prices over a very, very limited number of hours aren't what we lose in this process. I don't think we'll be glad to have that be the result of any of this.

MR. O'NEILL: Can I just clarify this whole issue about being paid marginal costs? The model that we're working with in standard market design and in other places doesn't have the market clearing necessarily at marginal cost of any generators. When there's a shortage of generators, it clears above the marginal cost of every generator in the market. And those are returns to investment. So that it's a misnomer to think that these markets are clearing at some generator's marginal cost. They may on occasion do that. But when the market is in short supply, they're going to clear a lot higher. That's a

scarcity rent. That's not an exercise of market power, and that's not what we're talking about.

MS. SIMON: Good. I would encourage you to convey that concept in any follow up in this proceeding as well.

MR. McLAUGHLIN: Julie, on that regard, though, here in the short term -- and you talk about peaking units and certain categories -- would it be best just to take them off the table in our market-based approach for now and put them back on a cost basis until we get standard market design and some other things? Because you're arguing you're concerned about our market-based solution not generating sufficient funds under certain constraints and certain parameters. Is it better to move them back to cost until the environment is better for them?

MS. SIMON: I think what you just heard is that people aren't interested in doing merchant investment on a cost basis. So if you want merchant investment, then the answer is no. And we've spent a lot of time, as Dick O'Neill says, genuflecting at the altar of divestiture. I can't see why it is that you would want to encourage more utility construction of power plants in this process. So I don't see how to get to that issue unless we proceeded very carefully with respect to sending the right price signals to get merchant investment.

MR. McLAUGHLIN: I know. I'm just still trying to get, though, to in the short term, rather than a proposal that's totally unconstrained, let the market do what it wants to do, what can we do? And I'm still striving to find that.

MS. SIMON: I don't want to be repetitive because I know there are time constraints. I think we've made a number of very specific suggestions. They're in the two pieces of paper that we sent you, and we urge you to consider them.

MR. CADWALLADER: I'd like to address the ability to raise money. I think there are two issues here. One is whether the returns on the market are high enough, and I think there may need to be some sort of capacity market or reserve market that provides that additional funding for peakers and other units that don't normally run or are very expensive to run.

I think part of the problem is that we have a certain level of reliability that we want to achieve and maintain. And in order to do that, you may have more capacity than a competitive market would normally build. And in order to provide returns for that additional capacity, you need to have some sort of reserve or capacity payments that are done in addition to whatever they're getting in the energy markets.

The other thing I think is risk. And I think if we have a situation where we're able to curb the exercise of market power and anticompetitive behavior, we actually reduce risk in the market. Because it's much, much easier to predict what prices will be when you're only looking at marginal cost pricing rather than trying to include in that also the ability of people to bid or withhold capacity from the market. So I think in terms of risk, we're actually reducing risk by trying to get a handle on market power and its exercise.

MR. NORLANDER: I just wanted to clarify, when I've talked about markets clearing at the marginal cost, I had assumed a capacity market. Otherwise, definitely you would need -- that last peaker would only get its marginal cost. It would never recover its fixed costs. And so the better way to do that is to require the load-serving entities who are participating in the ISO/RTO markets to acquire capacity. And then they will make the decision whether to build or buy a long-term contract or go to semi-annual auctions or something of that nature. And that buy, build merchant or LSE building decision would fall out somewhere in that calculus of each party's decision.

I would note I think in areas of the Midwest, public service commissions have been directing the distribution utilities to build. I think in Wisconsin

they're building and in Iowa they're building. But the issue comes, could they have acquired a 20-year contract? What's the difference? What are the costs in reliability and other preferences of the state as well as the players out there? And I think that all can be left vague in the sense that it will shake out in different regions in different ways.

MR. LARCAMP: Should we expect that the capacity credit is going to at least be equal to the annualized cost of a peaker? I mean, 87 cents times 12 doesn't give you much in the way of a contribution to fixed costs of a peaker in New England, which was what some were arguing for the capacity credit in New England. So I'm just saying, should that be sort of our measure about whether things are working correctly?

MR. CADWALLADER: Connecticut had advocated a higher number than that. I think you may need to vary the amount depending on how much reserve you want to motivate. If you need to motivate more reserves then you have a higher number out there. If less reserves, then you can have lower numbers, depending on where you want to be with regard to the reserve number. But that number has to be carefully thought about in terms of what a peaker can expect to get over the course of a year at a marginal cost energy price and then what it needs in addition to that to make itself

whole. But I think that is a number that can be calculated.

MR. O'NEIL: One point on Dan's last point, and that is that I think one of the things you have to take into account is to what extent would the peaker, in addition to revenues from a capacity payment, expect to earn, similar to what Dick talked about, in terms of scarcity rents when the actual energy is dispatched? So it's the whole package that will decide whether it's an economic investment.

MR. HARVEY: I'd agree with that. It's between the ICAP and the energy market. Somewhere they've got to recover enough money to justify the cost of the unit. You've got to look at them two together. And the questions about is anybody entering in a cost base, building plants for cost? Yes, there are lots of people who are contracting forward. And it is a cost-based contract. It's indexed at gas or something.

But again, an LSE isn't going to contract forward at cost if it can rely on capped prices that are less than that. So it has to be an incentive. And in the Midwest where I've been working a lot for the Midwest ISO, the people have talked about they've got an innovation out there with the utilities that a lot of them after '98, '99, have policies that they, when the price goes to 150, they ask their industrial customer, would you like me to buy some electricity for you? And up to 150, it's a utility rate.

But when the price is over 150, the customer is invited to decide whether they want to keep consuming. And it produces a lot of elasticity. But you have to have the willingness to let the price get there.

MR. HUNGER: I got the sense that there was some agreement that if we kept penalties or made it clear that penalties only applied to the specific entity engaged in some sort of either exercising market power or some sort of anticompetitive behavior, and we put out some reasonable exceptions, like small plants, hydro facilities, things along those lines, that there was a least some agreement that that might be something we could work with.

But I also heard -- I think I heard Julie saying, and she raises an important point, that people who participate in bilateral markets maybe ought to be exempt, because there is the story of the sophisticated buyers and sellers. I think that's an important point, but I don't think I agree with it. I think if you have a market, a bilateral market that's not competitive, someone could exercise market power. But maybe I'm wrong. But I want to see, is there any agreement on exempting people who are participating in bilateral markets as a stand alone?

MR. CADWALLADER: No. I think that market needs to be policed in the same way. And even though you may have sophisticated buyers at one level, ultimately you've got

consumers paying the bills, and ultimately you've got suppliers that can exercise market power unilaterally. And I think that's a situation you need to get under control.

MR. HUNGER: I may be mischaracterizing Julie's argument.

MS. SIMON: Not a bit.

(Laughter.)

MR. O'NEIL: I would concur that bilateral should not be exempted, but I think you have to bear in mind that typically, a bilateral agreement, if it's for a term of a years, some future term, was negotiated and struck at a particular point in time, and FERC historically, even in the regulatory context, has been engaged in sell-side, not buy-side regulation.

So someone may make a bad deal, and they made a bad deal. The question is, were they negotiating the deal in a market that was competitive, or was it a market that was noncompetitive such that it would be a different test I think as to whether or not that particular contract was valid.

MR. HUNGER: It seems like a much trickier problem to unwind, because it's not like there's a single clearing price where you can say, okay, they managed to raise the market clearing price by \$10 and it was a 50,000 megawatt market. How much does it bleed over into other

bilateral deals?

MR. O'NEIL: I agree with you, it gets complicated. Because let's say someone has put in a fixed price, then they have to go on the hedge with gas.

MS. SIMON: And how much are we going to be willing to protect the supplier in that situation? If you want buyers coming in and saying, well, the supplier overcharged me, do you want suppliers to be able to come in and say, well, I guessed wrong on the gas?

The concept of being able to unwind these transactions is a policy that this Commission for a number of good reasons has stayed away from on the gas side and on the electric side. You had ample opportunity. You had a series of PURPA cases not to go there or to go there, and you chose not to. The court has upheld that.

It just seems to me this late in the game, starting down that path unraveling contracts is not a policy you'd want to go after. But that of course raises the problem that I keep coming back to, is that organized spot markets already are largely competitive. They have RTOs in place. They have market monitors in place. They have regular studies. Those studies have consistently concluded that they are workably competitive, and so it's sort of circular in terms of where we're actually going with this.

If, Mike, what we're trying to do is figure out a

fix for this summer, it becomes very difficult to figure out what it is we're talking about.

MR. HUNGER: Julie makes a pretty compelling argument that the cure is worse than the disease for getting involved in bilateral contracts.

MR. HILKE: The other thing, bilaterals which go on for a while, you know, they are also presumably in some sense naturally capped by the fact that you can get new entrants. And if a contract goes on beyond a couple of years or something like that, that's an alternative if they're facing high prices from incumbents who are offering those kind of contracts to, you know, find somebody else to come in.

MR. O'NEILL: Scott said something earlier. It says that if you find in the real time market that the generators are actively engaged in one of the other markets, that is, their capacity is completely sold, maybe you don't have to look at the bilateral contract because they haven't withheld from the market, which is principally the way we figure that they can exercise market power.

MR. HARVEY: To follow up on our earlier discussion, the forward contracts, when you talk about how do you get a cost-based rate for a peaker? Well, that's a forward contract. And if it becomes a forward contract, it's only good when my peaker loses money, obviously there

aren't going to be any forward contracts at cost.

MR. CADWALLADER: I think the main concern is to get the spot market right. If you get the spot market right, then the forward market is necessarily going to have to be consistent with that spot market. And I think to that extent you alleviate a lot of the concern with regard to the forward markets.

Because if I know I can buy in the spot market at a competitive price or buy in a forward market at a less than competitive price, then I always have the spot market to fall back on, and I think that provides some restrictions, some constraints to the forward market.

MR. LARCAMP: I've got one for Mark. Do you have any way of giving us a rough ballpark of your opinion about what of a percentage of the capital difficulties that merchants are facing is due to this particular problem in the open-ended refund versus the whole reporting, you know, bringing debt back on the books type of stuff that we read in the newspaper every day? Can you hazard a guess for us?

MR. JACOBS: Dan, I guess my view would be that I think this issue has largely flown under the radar screen for the investment community to date. I think the problems you're seeing in the credit markets and in the equity markets right now that these companies are facing are all related to other issues.

I think if this issue came to the forefront, it could have an additional material negative impact on those markets, but I don't think any of that is in the market right now.

MR. BARDEE: I'd like to thank all of our panelists. It's been an interesting discussion. We'll take a short break now here and start back at five of twelve, please.

(Recess.)

MR. BARDEE: If people would take their seats, we will begin the next part of our agenda.

(Pause.)

We have a pair of microphones set up here in the room, and the intention here is to allow members of the audience to come up and make statements. If you have statements you'd like to make, I would ask that you limit them to five minutes as we did with our panelists earlier in the day. Staff may have questions based on your statements or otherwise, and hopefully you could enlighten us with answers to those questions.

With that said, let me turn to the gentleman at my left.

MR. REITER: Hi. I'm Harvey Reiter. I filed comments on behalf of the Sacramento Municipal Utility District and the State of Michigan and the Michigan Public

Service Commission and the New England Conference of Public Utilities Commissioners in this case. There are a couple of points addressing I think some of the questions the staff had raised that I'd like to focus on, one of which really didn't get much discussion earlier today.

There was a mention of whether to make this an interim rule or not. And I think there's one respect in which that would not be a good idea, particularly because of the structure of the Federal Power Act. The First Circuit has held that market-based rates are regulated rates for purposes of the Keogh doctrine, which has very serious significance for remedies for consumers in the case of collusion. Now I know one of the panelists earlier said there's really been no evidence of collusion generally in the industry. That's great. I hope that remains the case. But, you know, historically, the Justice Department gets involved in price fixing cases against companies in industries that are undisputably workably competitive. Every year it happens.

And what happens if you had no remedy similar to what you proposed in the rule that you outlined several months ago for price fixing or collusive activity, collective market power exercise, then consumers may be left without any monetary remedy for collusion that took place at some time in the past, whereas if the industry wasn't

regulated at all, they could at least bring a price fixing case in the antitrust courts.

So I don't think this should ever be an interim measure, at least with respect to protecting consumers from collusive activity. And that would be something I would urge you to think about.

MR. BARDEE: Let me just a question to make sure I understand your point there. Are you suggesting that if we did this on an interim basis, the court might construe that as preventing the Justice Department, for example, from going after similar behavior under the antitrust laws?

MR. REITER: Well, the Justice Department wouldn't be precluded, neither would private litigants from going after collusive behavior. But where the rate is regulated, the remedy would only be prospective and injunctive. There would be no ability to obtain refunds where there would otherwise be if, for example, there were a price-fixing conspiracy uncovered and the victims could get recompense. So that would be precluded if you didn't continue what you've proposed in here by way of remedy for collusive behavior permanently, not just on an interim basis.

There were two other general topics that were raised, and I just want to touch on them briefly. One was the issue of uncertainty. We have suggested, Sacramento and

the state of Michigan and others, that the Commission has a fair degree of latitude in two respects.

One is it has prosecutorial discretion to the extent there are complaints and people are worried about going after small fish or creating unnecessary uncertainty, the Commission can husband its resources. It can decide what are the cases that are important to go after. It has case-by-case authority to decide whether to take up a complaint.

And also with respect to that, if what the Commission is after is bad behavior -- collusive, exercise of market power or unilateral exercise of market power -- then it seems to me that common sense should prevail in a lot of these cases. And here I would go back to the Commission's historic approach to regulation of fuel clauses. The Commission's fuel clause regulations typically included a provision that said that the seller was allowed to pass through only just and reasonable fuel costs. And as a result, utilities were subject to a refund obligation for passing through, for example, imprudently incurred costs. The Commission didn't define that term any more precisely than just and reasonable, but it was a workable standard. And case by case, a company would be free to show that its costs were prudently incurred.

I think one of the panelists spoke about whether

you should put the burden on the complainant rather than on the company that is the subject of the complaint. Under the Commission's prudence review, there's a different approach. The burden is always on the company to justify its rates as just and reasonable. If it has a filing, it's got to prove that they're reasonable, but there's a presumption of regularity that it's not acting imprudently.

If you have a workably competitive market or one that the Commission has adjudged as such, one way to approach this is simply to leave the burden because it would be 205 filing subject to review, on the utility or on the seller in this case, power marketer or generator, whomever, and put some onus on the complainant to come forward to raise a serious doubt about whether there had been the exercise of market power.

One last point I really wanted to just touch on which was the issue of time limits. This again goes back to the way the Commission has approached the fuel adjustment clause cases. The Commission itself has said that in the fuel adjustment clause cases, it could conceive of no reasonable basis, which was the term I think they used in a couple of the cases, from imposing any time limit on the Commission's investigation of whether a filed rate was violated. And that's what I think you're talking about in establishing this new rule, establishing a new filed rate

that requires the passthrough only of just and reasonable costs that don't reflect the exercise of market power, either unilaterally exercised or exercised as a result of collusion.

The Commission has prosecutorial discretion, as I said, but there may be instances where it feels, for example, the perfect case is in collusion where it may take years to uncover a conspiracy, and the victims would be left without any remedy if the Commission decided there was something that needed to be corrected but had self-imposed a limitation on its ability to ensure compliance with the filed rate.

Thanks.

Mr. McCLIVE: My name is Tim McClive. I'm Chief Economist with Edison Electric Institute. And I do have some comments, although some will be based on the filing that we made and I will not hope to be as articulate or cogent as some of the filings, so please bear with me.

EEI definitely supports the development of stronger, more competitive markets. We've been on record for that for several years now. We are encouraged by today's panel discussion and by the opportunity for the panelists who appear and talk with you, but I am a bit concerned that one of the fundamental points which we had raised in our filing was not treated. And that's the

question -- I should say our skepticism about whether the order is based or has a reasoned basis and whether FERC has the legal authority under the statutes of the FPA and I think it's the APA to do this work, or to make these changes.

In particular, we're concerned about -- we believe that market-based rates under Section 205 can't be conditioned by requiring a waiver under 206(b). The waiver in question is that it would intentionally -- or that 206(b) was intentionally written for cases of individual utilities and not such a broad sweep as this has done. But since I'm not a lawyer and I won't pretend to be one, I won't try to garble that anymore, but we have raised those concerns.

In general on the economic side, when we saw the order, we became very concerned about the definitions of "withholding," both on an economic and physical basis. As is evident in our filing, we reached out to Scott Harvey and Bill Hogan to ask what they thought about this, and we sponsored a paper which was attached to our filing. We strongly support the statements and the analysis which Scott presented in that paper.

Today's discussion has been very interesting. As I go through my notes on it, I'd like to touch on four or five areas. I'm concerned that some of the questions about trying to get pragmatic advice and how to measure withholding start to look like establishing a set of very exacting rules and formulas. And it could become bigger than the U.S. Tax Code. I'm not sure how a competitive market could work well if every market rule has lots and lots of subsections. Under this circumstance, this is appropriate under that circumstance, that is not appropriate.

There was also a tone in the room or in the discussion today about looking at the short-term, looking at the summer. I'm not sure if it was a hypothetical that was being used for purposes of eliciting comments or if it was an underlying policy position. But it reminded me of a comment that the Chair made last week at a lunch. Somebody

asked him about price caps. And he said, well, in California, the situation was when the kitchen's on fire, you don't look at what's in the slop bucket, you just throw it. He followed that up and said, and the fire went out. And he paused a few seconds, and then he said, but we made some mistakes, we sent some bad signals, and I'm hoping that a policy, such as changing tariffs to include a refund provision would not be contemplated as a short-term fix because I don't think changing a tariff is short-term at all.

On other issues, I think as Scott said, reasoned people can disagree, and I'm sure there's a lot that I heard with that I agree with and I don't agree with. I won't elaborate too much. It's a diverse group but I don't think it's fully representative of the industry, and I trust that the Staff looks at this as an information-gathering session, but not a dispositive display of the different positions in the industry. And I would reiterate a proposal that Edison Electric made that perhaps a NOPR for wider public input would be advisable in this critical area.

I'd like to talk about just a few points. As I said, we support competitive markets. We believe that a prospective approach is much better than a retrospective approach; ex ante instead of ex post. Demand side response is very critical. It is necessary, I believe, that the

market rules be set up so that the wholesale buyers can build in how much they're willing to buy at different prices. That's different than bidding in to sell their negative generation but to be able to bid in as the suppliers bid in how much they're willing to sell at different prices. Demand should be able to bid in on how much they're willing to buy at different prices.

Divestiture has been brought up. I don't think it's a first best solution. I think there are many circumstances where it may be an inadvisable so I hope that is not pursued as a first best solution. There was discussion about filing and publishing cost data as part of making the markets more transparent. That concerns me because I think it raises antitrust issues. I would be surprised if the steel industry or the cattle industry or the CHIP industry was submitting their cost data and publishing it so that their competitors could see what the costs were. I think that raises problems.

And in general, the wide application of the refund provision would cast a very wide net. I think it would inhibit dynamic participation. It would almost be like a very broad but insufficiently designed market power screen that catches all of the possible transgressors but also catches a lot of innocent participants and precludes them from being in the market.

And as I stand here, I wonder if I'm making sense which I hope I am. I think I've run to the end of my comments. I appreciate the opportunity to make these statements. I look forward to more work on this 206 proceeding.

MR. TERZIC: Good morning or good afternoon. My name is Branko Terzic with Deloit & Touche. I have filed comments in this earlier for the Electric Power Supply Association and just to amplify that a little bit, I want to commend to you the testimony this morning of Mark Jacobs of Goldman Sachs. It's from that perspective that I rise to talk to you. I've been spending about half of my time in the last three years with Deloit in Eastern and Central Europe working on the emerging markets. I want to compliment this Commission and its orders because what you've been doing with ISOs and RTOs is closely followed there as they're going both a restructuring of their industries and are looking at privatization simultaneously. These are very difficult two steps to take but the model is among others here in the United States, PJM in particular, how that's operating.

The example of what not to do has clearly been California, but I think the decisions of the Commission have all be correctly along the lines of understanding that the long-term benefits of competitive markets will be superior

to continuation or any idea of continuation of our 100-year-old cost of service methodology. That methodology served us well all the way up until the period of the nuclear power plant building and the oil shock. After that I think we realized that we needed more incentives in the one segment of the electric industry that would be amenable to direct incentives and that is the generation segment. I speak on incentives, having led a task force here on incentive ratemaking and I certainly want to urge the Commission to continue with the Order 2000 provisions for incentive ratemaking for the transmission, and I of course hope that all the state public service commissions will put in incentive ratemaking for the distribution as well.

My concern has been very narrowly with the blanket refund order. I think it was a tool that adds an additional degree of regulatory risk which does not need to be there for this Commission to do its job of ensuring just and reasonable rates. I have been dealing with European investors. As you know, we've had inward investment in the U.S. market, both at the generator/transmission and the distribution level, and I can assure you that this type of a blanket provision for refund is an additional level of risk which is hard to quantify and hard to determine.

If you do proceed down that path, the detailed rules will be parsed and looked at very carefully and will

create may additional risk as well. I think the Commission has adequate other tools. We're talking post-anti-index -- English is my second language, Latin wasn't my first, but I think what Dick O'Neill meant you're going to go in after the fact, or you're going to do retroactive ratemaking.

I've generally been against retroactive ratemaking. It does add uncertainty. The investors don't know what the actual earnings were. You don't know whether your company or your power plant will be swept under it or not. I think it will be very difficult to operate and it will add some difficult-to-quantify risk to what's already a very risky market, the electric power market, a robust market, a market that will grow and will need more electricity in this country in the future than we have had in the past. And clearly we need a set of mechanisms which will ensure that that capacity is there.

I commend the Commission for its concerns and its review of the power markets. I think the morning panel had a lot of very good ideas about some practical steps.

Clearly you have the tool of price caps. You've used that in a couple of areas. If you are concerned about very sharp spikes for the short periods of time, I think price caps are superior to coming in with the alternative which is in your order of having an investigation and possibly having everybody who participated in the market on that day or

during that period, subject to potential refunds and penalties. I think it would be an easier, simpler regulatory mechanism for you to use what the various parties have indicated, well there'll be some appropriate price cap numbers. I haven't done a study, I don't know the details of what's behind those but they seem to be reasonable.

Once again, we do have experience in natural gas and other markets where we can draw the conclusion that sometimes high prices are a demonstration that the markets work, not that the markets don't work. I think that this Commission has plenty of experience along those areas, to go back to that and to work with it.

With respect to some discussions on consumer confidence, I do an annual poll on consumer opinions on electric deregulation. It comes out every October. Given all the experience and everything that's happened with the California markets, there has not been a tremendous shift in consumer opinion. That poll is publicly available. You can take a look at it yourself. Yes we have more people that aren't even aware of what's going on this year than the year before. That is, we have less awareness this last year of deregulation and competition in electric markets than we did the year before. A lot of things have happened. The poll took place after September 11th, so people might have been distracted but in any event, I don't believe this Commission

has lost national consumer confidence. Congressional confidence, that's another issue and we deal with that all the time, but I don't think that's really the driver in this case.

We are concerned that in the long run, once again, consumers have access to better prices than they would under the old regulatory regime. Unfortunately, in too many states, the sale or the prospect of deregulation or restructuring was sold to the public on the notion that rates would go down immediately. That would be the only benefit and that would be the only good reason to do this. Even in states where the retail residential rates were below anybody's notions of cost of service where that statement would have been impossible.

So we are in this for the long run, this Commission is in it for the long run and I think that you're on the right track. I don't think that the refund mechanism, the blanket refund mechanism will accomplish your goal. It will certainly I think add to the cost and uncertainty. I would ask that you take a look at it once again and listen to my fine colleagues as well.

Thank you.

MR. ADAMSON: I'm Seaborn Adamson from Frontier Economics to provide the usual disclaimer. I am speaking on behalf of me, myself, and I, and not on behalf of any of

Frontier's clients. First off, as a first point, from the professional perspective, I absolutely would like to give my endorsement to the comments made by Scott Harvey this morning which I think were absolutely right on, and also to the comments of Mr. Hilke of the Federal Trade Commission which I thought were also right on.

Also being involved a bit in the capital market side with the comments from the gentleman, I guess Mr. Jacobs from Goldman, Sachs, being involved in the financing side to try and explain this to the syndicated loan market. It's not going to happen. You are, I think in this case, dipping into waters that are quite deep, trying to get the capital markets comfortable with this idea I think is going to be extremely difficult.

It's very interesting. I'm working with the power pool of Alberta, trying to help them develop a policy on this regarding this same type of questions, questions of economic and physical withholding. I think the approach there that's kind of evolving is something you should really consider which is really trying to make some form of at least qualitative assessment of the costs and benefits for imposing such a policy. The benefits may be for a few peak hours. Maybe you can see some immediate short run benefits. The long term costs, I think of the cost of capital and stuff, could be much higher, could be much more significant.

And anything that is a capital investment decision is going to have ramifications for consumers for many, many years to come which you really do have to consider. It's unfortunate I know.

Dick O'Neill and Dan Larcamp aren't here and they asked for some kind of practical points about implementation of such kind of policies as are being discussed here in the FERC Staff paper. I was going to point out three kind of I think practical examples, which I think can give us some guidance about a) some of the difficulties, and b) what will need to be considered if you try to impose some of these types of policies on withholding.

The first off is a recent case in the United Kingdom which is kind of been at this a bit longer than we have here regarding the application of what was called the market abuse license condition effectively replicating economically some of the same facts here. That was relatively recently thrown out by the Competition Commission, kind of the British equivalent of the FTC, as being so vague as to being completely unenforceable and arbitrary. If you want some kind of practical examples of how such a policy might be viewed in the courts, obviously in different jurisdictional context, but I think some of the economic lessons are quite german. You might want to look at some of that information. I'll be glad to provide it to

anyone who is interested.

The second one is really much closer to home. In fact, it's going on right here right now right next door.

The California Refund Case which I've had the pleasure or displeasure of being involved with for I guess almost a year now. The root of this questioning is about determining competitive outcomes based on some notions of marginal costs after the fact. I reckon there's 200 lawyers next door at five hundred dollars an hour. Those lawyers have been doing a lot more than sitting next door. As part of kind of an exercise for a few moments, one time in an airplane, I tried to estimate what the legal fees on this case for all the parties have been. I'm not sure I can count that high.

But the process of going back and trying to determine what prices should have been in extraordinarily complex markets after the fact is, as Mr. Hilke noted, a legal process that will not be short circuited by a few rules, and is just extraordinarily time consuming, and I don't imagine there's enough people in this building to deal with all these cases. So while professionally I agree with Dr. Harvey's assessment of the difficulty of doing this, as someone who has an expensive home renovation project going on, I must admit it sounds like the best thing since sliced bread. I'm going to build kind of a Dallas-style Southfork out behind my house.

(Laughter.)

MR. ADAMSON: One other question. Mr. Larcamp or Mr. O'Neill pointed out was about these energy limited units and on the NOx units. Again, I think the California case going on next door can provide us with a few examples about how difficult that actually is to incorporate into these assessments of competitive market outcomes. Even when there is a traded NOx product, which there certainly is for the case of the Southern California Air Quality Management District, the so-called reclaim market, RTC market for NOx emissions from thermal units in Southern California. There's quite a large market for those quite well-traded prices available from brokers' prices quoted in the newspaper, prices quoted by the California ISO Department of Market Analysis, and in the hearing next door, the Commission decided that it was too complicated to try to build those into prices and it excluded those from prices from these OMCPs. The Commission itself noted that this was sound economic theory and 30 seconds with a pocket calculator will tell you that you're not going to get anywhere close to the right answer without incorporating this. But they decided that even though, where there is a traded product for NOx that building this in makes kind of recalculation of prices after the fact very complex.

So every time you think about what's going to be

necessary to build in estimates of NOx prices into some of these markets, at more than a very kind of vague, 50,000 foot level, you might want to look back in the record at what's been decided in the California case. At many points, if NOx prices are high enough, and when NOx becomes such an important component -- I mean some of these units are almost using natural gas as a byproduct and they're mainly burning NOx permits -- that's a real cost. Environmental goals are environmental goals and these were environmental restrictions placed upon them by the state and federal environmental authorities for very good reasons. I don't want to breathe all this stuff.

So, you know, the construction of marginal costs is the average versus incremental heat rate. How do we incorporate all the start-up cost? How do we incorporate people's perceptions of risk of outages and all this type of stuff.

As Dr. Harvey pointed out, this becomes micro-management in extreme, and I think the real logical economic question with regard to this is, if competitive forces cannot be relied on to a greater extent than this, it seems like we have about the worst possible form of regulation, which is an attempt at regulation on a marginal cost basis. That, to me, seems almost worse than just going back to the old cost of service thing, and yes it did produce very

efficient investment incentives but at least it kept the costs of capital very low, which is very important in a capital intensive industry.

Thank you.

MR. PRATER: My name is Vann Prater. I work for Dynegy, which is an energy trading and independent power producer located in Houston. I'm actually from our Houston office.

I'd like to point out right from the start that I sit on the trade floor with our traders and our asset folks every day. I'm not an attorney. I'm from the business side of our operations.

First of all, we have a handout in the back of the room that addresses many of the points that were in the staff paper, and addresses many of the questions that came out. I would like to refer you to that for your further reading and our positions on some of the issues that were addressed.

I would also like to very much support many of the comments that were made by several of the panelists today: Dr. Harvey, Julie Simon, John Hilke, Mark Jacobs; and also a couple of the ad hoc speakers, Mr. Terzic and others who have been up here this morning.

Categorically, we believe that this order is fundamentally flawed, and is absolutely not tweakable. It would be like rearranging the deck chairs on the Titanic, which could bring actually in our view an entire industry down and set us back many, many years.

We ask in our paper, why would the Commission

jeopardize wholesale market generation investment and the future of restructuring with an approach that many people feel is perhaps an unlawful approach to an unsubstantiated problem? We go back to the question that was asked many different times this morning, and that is: what really is the problem we're trying to address?

Dynegy looks around the country. We look to the northeast and New England, where we have favorable reviews from the market monitors. We see no problem there.

We look to the west, where there are region-wide measures that are currently in place. We see no problem there. We look to the south, where we have exclusively bundled sales by integrated utilities to retail customers.

We see no problem there. And in the midwest, we have more than adequate generation supplies precisely because FERC did not intervene in the markets with the needle-like price spikes for a very limited number of hours in 1998 and 1999.

In fact, in our handout, we have a graph that shows that current summer prices for 2000 and 2001 in the midwest are one-third to one-half the prices experienced in '98 and '99. We don't see the problem there. We ask: where's the problem, and what are we really trying to solve?

Several of the speakers today who seemed to support what the Commission is trying to do were suggesting sweeping changes that do not appear limited to this summer.

Yet time and time again I heard commenters refer to, what do we do for the summer.

I think many of the folks here are mixing apples and oranges. Are we trying to fix a long-term problem or are we trying to fix a short-term problem while we get about the business of restructuring?

If we're trying to solve a short-term problem for this summer, we don't see the problem and we don't see any need to invoke what the Commission is trying to do. If it's a long-term problem we're addressing, we believe that we need to get on with the job.

This is the best and only remedy to any potential market power problems. We need a holistic approach that includes many elements. We believe this includes structural remedies rather than behavioral remedies. We talked a lot about the distinction between the two today.

Behavioral remedies, such as are being proposed here, really won't work in the long run, and we need structural fixes. We need demand response. We have to have load that will respond to price signals and get away from the vertical demand curve so that we do have a truly functioning market. We need to get the price signals out there.

We heard Dr. Harvey talk about the situation in the midwest where, if prices get to \$150, they call up the

industrials. Would you like us to continue to buy, or do you want to drop load? What a great fix.

Seams issues have to be addressed so that we have seamless markets from one region to another, so that we can move power with few transaction costs and minimal seams issues. For example, we need to be able to move power between New York and PJM and vice versa. Currently that's very difficult to do.

We also need capacity markets as a component of what the long-term industry should look like. We need to have all load-taking service under the same terms and conditions from a single tariff. We need FERC to get on with the issue of standard market design. We need to have barriers for entry for all participants to be reduced so that we can create the level playing field and increase supplies that will bring about the truly competitive market that will benefit consumers.

Finally, we need to get on with the business of RTOs, where we have adequate monitoring in place of both the market and the actions of the RTO.

One other comment I would like to make is that the term of calling this a hedge was bandied about several times this morning. The view was expressed that perhaps a blanket, market-based rate refund is a hedge.

Coming from the trade floor, in no sense of the

word as I know it from a trade floor perspective can this be construed as any kind of a hedge. When my traders on the trade floor use a hedge, they are doing it to hedge a risk that can be quantified, and it's done ex ante for a particular products. What we're talking about here is an unquantifiable risk on an unspecified product, and it's done ex post.

So clearly, in my view, this is not a hedge. And if it is a hedge, let me be the first to line up so that I can buy puts on Enron based on the stock price of six months ago.

Thank you.

MR. WEBB: My name is Bob Webb, a professor of finance at the University of Virginia. I'm also editor of the journal, Futures Markets, which is an academic publication which specializes in articles on securities, futures markets, options and swaps.

I think the proposal that the Commission has put forward is well-intentioned, but unfortunately I think also misdirected. I think that it would not achieve its objectives, even if modified. I believe further that a lot of the consequences, the unintended consequences, of this proposal are entirely predictable.

As some of the speakers have pointed out earlier today, if you adopt a proposal like this, you're going to

increase regulatory risk. One of the basic axioms of finance is that for nondiversifiable risk, the more risk there is, the greater the expected return required by market participants. This means that companies will increase their prices. It also means that you would have a higher cost of financing, as Mark Jacobs pointed out in his comments, which means less investment in new power supply.

Further, as I believe Scott Harvey pointed out, if you extend this refund provision to all market sellers, including those without any perceived market power, then you will actually exacerbate the situation rather than improve it in terms of providing additional supply.

I think it's important to realize that power is a commodity. Like all commodities, there are periodic commodity price spikes, and we shouldn't be surprised to observe them in this market. As in other markets, they are oftentimes more pronounced in spot markets than in forward markets.

Having said that, I believe, as Julie Simon pointed out, in many of these markets there are hedging vehicles which are used by buyers to protect themselves from this risk exposure. It should not be really the Commission, through this back door strategy, protecting these buyers who do not protect themselves.

But probably more fundamental, it's important to

realize that prices are signals for resource allocation, as Professor Friederich von Hayek, the Nobel laureate, pointed out years ago. Prices reflect and convey information.

The question that the members of the Commission and the staff should address is, do they really want to see FERC-like proposals applied to other commodities in other commodity markets? I think the answer would be no.

Thank you very much.

MR. MOSHER: I'm Allen Mosher from the American Public Power Association. A few quick remarks to follow up on some of the questions that were brought up mostly by the Commission Staff here.

As I understand, you're really trying to focus on what to do right now in the short term rather than on the long term. I think we'd agree with EEI and others that we ought to have a rulemaking to address market power mitigation in the long term. Clearly, we've got too many other things to do right now to take this issue up front and center, so I'm going to try to focus on the short term.

Regarding price caps, Julie Simon from EPSA had suggested a thousand-dollar damage cap. That's a workable starting point. I think in general that's probably too high, but we can at least talk about the number. I would suggest, however, that we probably need a damage cap at a lower level for medium-term transactions today of a month or

so. The idea of setting a thousand-dollar cap will allow a lot of market power to take place in longer-term transactions.

On the refund condition, it's got to apply to all transactions. If we exempt a category of sellers, clearly there's going to be migration from the regulated markets to the unregulated, or rather the mitigated to the unmitigated markets, and it probably ought to apply across the board. I realize it's complex, but at least as a matter of principle it ought to apply to all transactions.

Even in long-term markets, I think you can have market power. You can have market power exercised successfully many times because the spot market doesn't work efficiently. It's a reflection of market power that pushes up prices in long-term markets. Clearly, I don't think we ought to exempt long-term market power from additional FERC scrutiny.

We also have severe problems with transmission access around the country. Just because you have a competitive market in the surrounding region doesn't mean that a particular set of buyers are not caught in a load pocket where they have one, two or three sellers. So clearly we need to be looking at those transactions as well.

This would of course also affect the price of the vaunted hedging contracts that are out there. If you've got

a high spot price and long-term prices go upward, then so do the prices for the various hedging contracts.

Regarding the window for which charges ought to be subject to refund, 30 days was also suggested by EPSA. That seems absurdly short right now, given the information that customers do not have about the nature of the transactions and the nature of the market place we're working in. Right now we've got a long lag before any kind of information comes out of the structured RTO markets in terms of what information customers have about who sold what to whom, or the quantities that were sold. We need to have additional information out there and use that information availability to guide the length of the review period.

Although the review period certainly ought to slide, it ought to be shorter for spot market transactions than for long-term transactions. I don't have a suggestion today, but we will certainly work on a recommendation.

On refund liability, there was also a discussion about what refunds a particular seller would be responsible for if he's operating within the market. If he charges -- either restricts quantity through economic withholding or physical withholding, should he be responsible for charges other than what he directly caused?

That's a real tough issue here. I'm not sure that we could go as far as the man from the Connecticut

Commission suggested, to make him, a particular seller, responsible for the entire overcharges within the market.

That would certainly produce the desired result in terms of not exercising market power, but it could lead to prudent withholding by sellers. That is, if they're going to be responsible for the damages caused in the market as a whole, then they're going to be very circumspect about whether they're going to offer a product at a high price. The risk-reward ratio would be off.

Conversely, it doesn't make any sense within a market working under market clearing prices -- that is, a structured market -- to make that seller responsible only for the economic damages associated with his own sales. If he withholds quantity, exactly what would he be penalized for? Yet there's no amount for which you can assess the charges to him.

So the question is, should the market as a whole be responsible for having their transaction prices mitigated back to the competitive level? And I think that is the right answer there.

In response to something that was also I think asked by Dan Larcamp, is anybody buying power ranging through cost-based rates any more? Yes, public power is; cooperatives are also. We believe in long-term contract arrangements. We go out in the marketplace every day to

look to see what the best deal is for our customers. When we can't buy cheap, we build.

In many cases now, because of dysfunction within the market, we're actually building capacity when many of us would prefer to be out in the marketplace buying long-term contract arrangements. We think in the long term these problems can be addressed, but right now we need some immediate relief. That's why I suggest the measures I put forward here.

Thank you.

MR. SAVAGE: Paul Savage of NRG Energy. I'd just like to make a few comments.

Echoing the concern of the statements that have been made in the past, one thing I think you need to do is define what the concern is. I heard an unstated, generalized concern about this summer. The problem I see at the fundamental level, where you're going is not going to be a short-term solution. Nothing is actually as permanent in essence as a temporary solution.

If you have this refund condition, my concern is that it will be permanent. And one of the reasons that I can say that, and I believe that, taking a look -- if there is a generalized concern, it may be in the areas where there's a shortage, or insufficient supply of generation, or insufficient ramping capability for certain generation.

You're creating a system that's going to be very hard to finance any transactions.

You have the spokesman of Mr. Jacobs, and you have the spokesman of the professor there, Professor Webb. Try to have anyone finance transactions when in essence, the only thing you're guaranteed without some indefinite threat of litigation is bidding on a variable-cost basis.

The ability and the difficulty of determining what is, quote, an appropriate after-the-fact price is incredibly difficult. I think you have to look at that.

You actually started going into somewhere halfway between regulated cost of service and a market system. You're going to have none of the benefits of either and all the difficulties of all of them.

Clearly if you have a system where there's a refund condition and there's a push to have variable cost pricing on a short-term basis, that eliminates any incentive for anyone to have long-term contracts, which has been a hallmark, I think, of where the Commission is going.

Clearly what you want to have -- you want to have a policy where there'll be an incentive for LSEs to have a portfolio supply, just like any commodity.

You're creating a system where there's no incentive. You're pushing an issue to either a variable cost basis on real time -- what's the incentive for anyone

to contract on a long-term basis?

I think that there's also a tension between where you want to go to in the future with the standard market design. There is a problem in a market between price certainty and market liquidity. If you make the markets, we won't know until we're finished for two years, six years, six months.

I think you're going to have a real hard time with people taking the risk, because you're increasing market risk for not only generators but all suppliers. And correspondingly, you're not creating any basis for them to be compensated for that. It's rather an unstable situation that you're moving towards.

MS. NEESON: My name is Judy Neeson. I'm with the Williams Companies, here on behalf of our energy marketing and trading company. I just want to reinforce a couple of points to be on record.

We associate ourselves with the comments that Julie Simon made, that at this juncture in these markets we would be willing, for the purpose of adding greater certainty than would be the case under the FERC's proposal, to have an open-ended refund condition, to look at something like the thousand-dollar circuit breaker, whatever you'd want to call it. That in our judgment is something that we don't come to easily, because we don't think it's really the

right thing for the markets, but we do recognize that it's very critical to have greater certainty and more public confidence than there has been in the recent past.

So in that spirit, we come to say, perhaps something like that till we get the market design right is the right way to go. And we looked at doing something beyond that when we talked about price screens as a group, and other measures, the things that we think could have the potential to brainstorm. We've gone through that exercise, and have come up short.

Dan Larcamp has asked for more specificity. I can understand you need some solutions right now. But frankly we've gone through that thought process internally, the best that we can, and we really struggled to offer you something that we think has the right answer from the cost-benefit analysis, and that doesn't have the kind of unintended consequences that we all fear. So we struggled to offer that up to you, frankly.

If you do go forward with something like a thousand-dollar circuit breaker, and do any measure beyond that, we think it is absolutely essential that you do put the kind of boundaries on it that some people have talked about here today. We think it is critical that you do limit it, as the Commission did in the case of California, to something like a 30-day period for people to evaluate

transactions and make judgments about whether there is anything to question.

Some people have argued here today that 30 days is not enough time. I recognize that that puts a burden on people to look at things. But again, we are not going to come up with the perfect solution here to go forward. We have to have greater certainty in these markets.

The comments made about the need to invest are very real. I think people know that. We do want to be on record as letting you know that an open-ended refund condition is something that we would find very untenable, and because of that are looking for some alternatives here today.

I also wanted to speak to the question of whether anything should apply to the bilateral market. From Williams' perspective, the answer has to be no. Again, there are other things to look at. It's not just, is there the possibility that there was some behavior that was bad for one hour that then you are going to translate that into long-term forward prices? Upon that basis, you would say, well now, all the bilateral contracts that we entered into for some period of time should be subject to some kind of refund. That would just not stand up to any kind of legitimate policy consideration.

Certainly, no one's coming to you saying, well,

where you have price caps. Then we should take that into consideration for maybe, the sellers aren't getting their due in the long-term contracts that are based on short-term prices that have those parameters, either.

Thank you.

MR. BARDEE: I'd like to thank everybody for attending today, particularly our panelists and the other speakers. It's nice to work on an issue where there's such unanimity.

(Laughter.)

MR. BARDEE: I would like to note that, per our notice of March 1, anyone who would like to file additional written comments, the deadline is March 22, with a 20-page limit. Thank you all.

(Whereupon, at 12:55 p.m., the meeting was adjourned.)